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FEDERAL RESERVE BANK OF NEW YORK



**ANNUAL REPORT
1980**



FEDERAL RESERVE BANK OF NEW YORK

April 2, 1981

To the Depository Institutions in the
Second Federal Reserve District

I am pleased to present our
sixty-sixth Annual Report, reviewing major
economic and financial developments and
this Bank's operations in 1980.

A handwritten signature in cursive ink, appearing to read "Anthony M. Solomon".

Anthony M. Solomon
President

*Federal Reserve Bank
of New York*

**SIXTY-SIXTH
ANNUAL REPORT**

*For the Year
Ended
December 31, 1980*



Second Federal Reserve District

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*Sixty-sixth Annual Report
Federal Reserve Bank of New York*

1980—AN ECONOMIC OVERVIEW

The Domestic Economy

The United States economy underwent wide fluctuations during 1980. Economic activity plunged into steep recession early in the year, bottomed out in the summer, and then rebounded over the rest of the year. In the financial markets, interest rates soared to record highs in March, plummeted from April through July, and then surged to new highs as the economy recovered. A few industries were especially hard hit by these economic and financial fluctuations. The automotive industry had its worst year ever. New home construction was throttled by the record high interest rates. And many thrift institutions, burdened by large holdings of old low-interest mortgages, posted sizable losses. By the end of the year the economy as a whole was essentially back to where it had been at the beginning of the year, and real gross national product (GNP) was only fractionally higher than two years earlier.

Despite the slack in the economy, inflationary forces proved to be severe and persistent. Early in 1980, inflationary expectations exploded, and there was an urgent sense that previous measures were insufficient to contain inflationary pressures. In March, President Carter announced a broad anti-inflation program and called upon the Federal Reserve to institute special measures designed to limit the growth of credit. By the end of the year, inflation, though remaining high by historical standards, had receded from the extraordinary heights reached earlier in the year. Still, inflationary expectations had not really abated, as monetary policy—notwithstanding its success in moderating the growth of money—was perceived as needing more support from other arms of policy.

THE DOWNTURN. In 1979 the well-advertised recession had not materialized and, as 1980 opened, there was a widespread perception that economic activity was on a plateau and that a contraction in the economy was not imminent. Inventories were lean everywhere in the economy, except in the automobile industry, and new orders were showing no signs of decline. Detroit was doing very poorly, yet the previous slump in domestic car sales appeared to have leveled off.

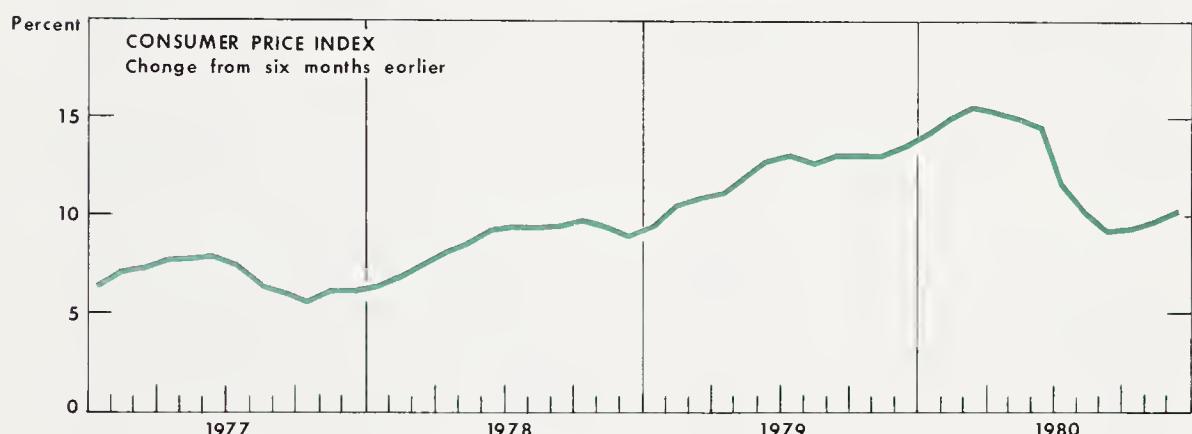
While the real economy was marking time, there was an alarming flare-up in inflation (Chart 1). The consumer price index shot up at an almost 17 percent annual rate in January 1980 and remained close to that in the following month. True, consumer prices had accelerated to double-digit rates during 1979, but most of that speedup had been related to the prices of food, energy, and homeownership, which tended to reflect special circumstances rather than the general inflationary environment. What was so disturbing about the spurt in the consumer price index in the opening months of 1980 was that it was broadly based, encompassing many other prices besides those of food, energy, and homeownership. A similar pattern showed up in producer prices. While the index of producer prices of finished goods had begun to accelerate in mid-1979, this had reflected the run-up in oil prices. However, when producer prices of finished goods other than energy and food surged ahead in early 1980, it looked as if inflation had taken a serious turn for the worse.

As these worries about inflation escalated, interest rates moved sharply higher. At about the same time, the Administration announced a \$16 billion deficit for fiscal 1981, whereas previous indications had been that the budget would be in balance that year. This accentuated the inflation fears even more. The bond markets came close to panic, and some observers began to question how much longer the bond markets could survive.

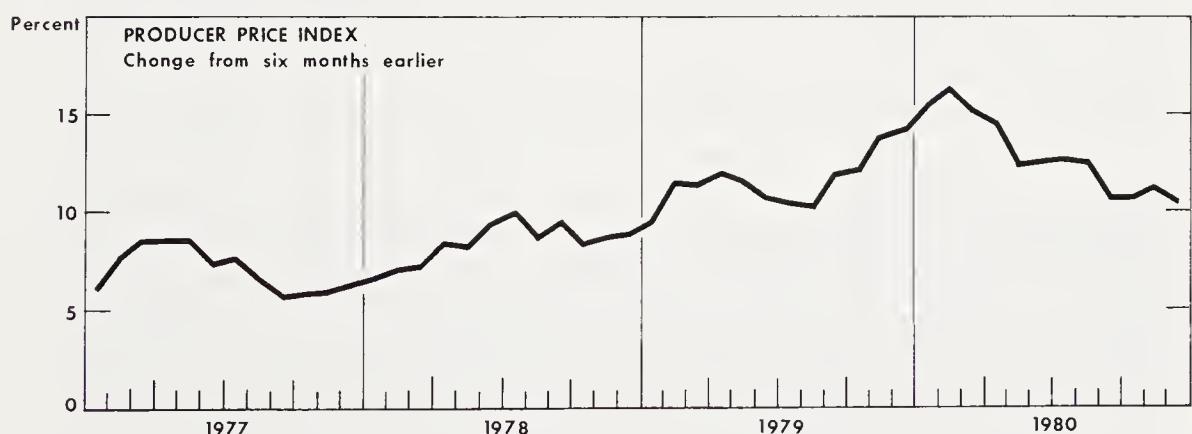
Faced with disarray in the bond markets and intensifying inflationary pressures, the President announced a new anti-inflation program in mid-March. Included in this program were a commitment to balance the 1981 budget, an extension of the wage and price standards established by the Council on Wage and Price Stability at the end of 1979, and a renewed appeal to the Congress to enact several energy conservation measures. In addition, the President invoked the powers granted to him under the Credit Control Act of 1969 to authorize the Federal Reserve to impose restraints on the growth of credit. Accordingly, the Federal Reserve instituted an extensive credit restraint program on March 14. The controls were aimed at limiting the growth of

overall bank lending and of unsecured consumer credit by all types of lenders, most notably through credit cards. Consumer credit lenders were required to maintain noninterest-bearing deposits equal to 15 percent of increases in covered loans. Altogether, only about half of total consumer credit was covered. Not covered by the program were secured consumer loans such as mortgages, home-improvement loans, automobile loans, and other consumer durables loans. At

Chart 1. ALTHOUGH INFLATION SLOWED DURING THE YEAR, IT REMAINED HIGH AT THE YEAR-END, BOTH AT THE CONSUMER LEVEL . . .



. . . AND AT THE PRODUCER LEVEL.



All data are seasonally adjusted annual rates.

the same time, the Federal Reserve imposed a surcharge of 3 percentage points above the basic discount rate on certain discount window borrowings by large member banks.

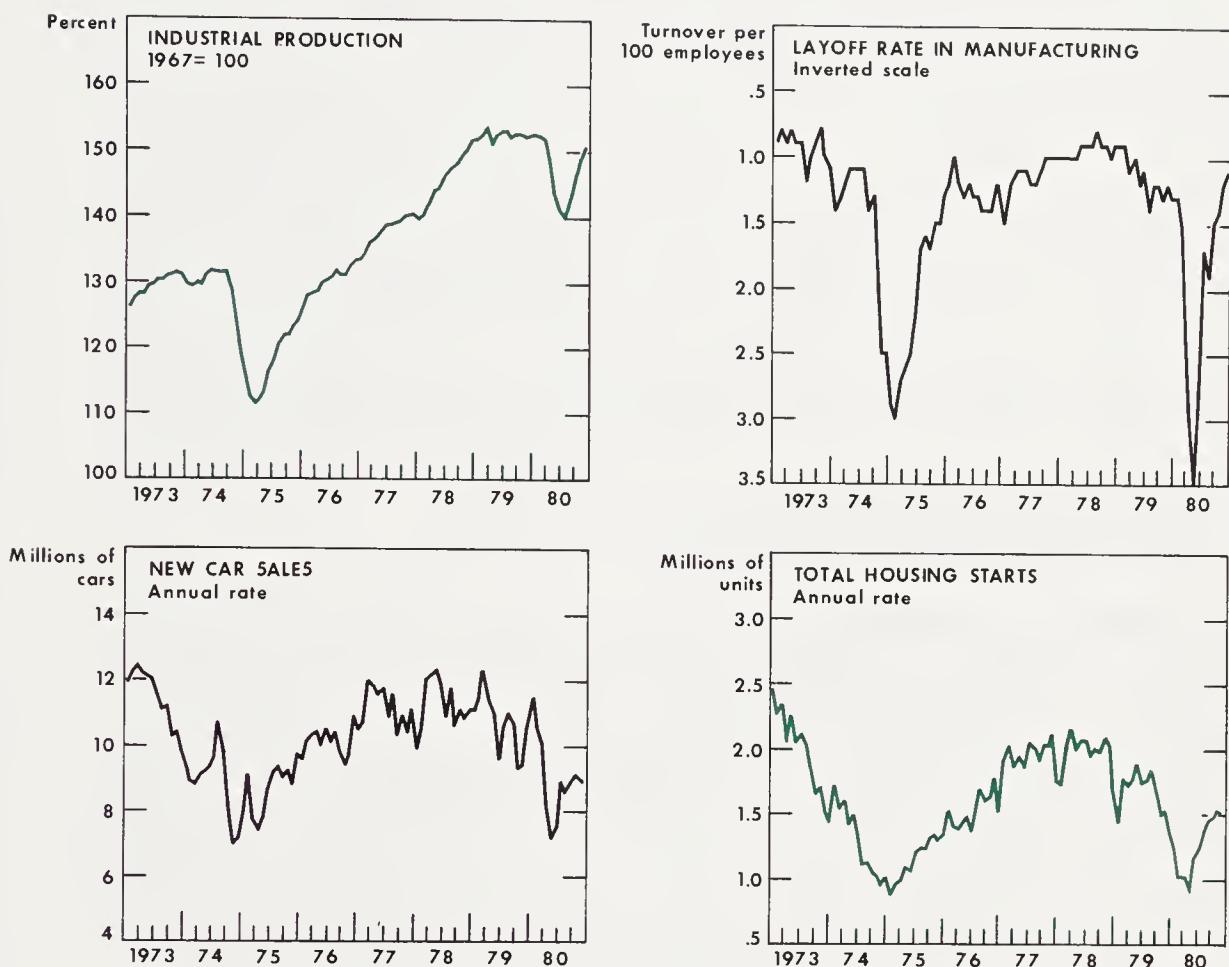
Along with the imposition of the credit controls, the economy skidded into recession. While January 1980 is generally accepted as the official cyclical peak, industrial production and employment remained fairly level until mid-March or so. From then onward, the downslide was fast and steep. Businesses reacted exceptionally quickly to the downturn in demand, cutting back production and laying off workers. By this prompt reaction, they prevented much of the inventory accumulation that occurs in the typical recession and tends to prolong the downturn. Industrial production plunged between March and June at as fast a rate as in the 1974 recession at its steepest (Chart 2). Real GNP fell at a 9.9 percent annual rate in the second quarter, the largest quarterly decline ever recorded during the postwar period.

The 1980 recession itself was largely the result of a collapse in consumption spending. In real terms, consumption spending plummeted at a 10 percent annual rate in the second quarter, and this alone accounted for nearly two thirds of the overall fall in GNP. In most past recessions other than the 1974 experience, consumer spending had generally been a stabilizing force, declining less than other components of demand. The plunge of consumption spending in the spring of 1980 was concentrated in durable goods, mainly motor vehicles and parts. Real consumption spending for nondurable goods and services edged down in the second quarter at a 2 percent annual rate.

Mirroring the fall in consumption spending was a sharp drop in instalment credit. Consumer instalment credit fell about \$8 billion from March until July (Chart 3). Not only did consumers cut back on their use of credit cards, which were covered by the credit restraint program, but they also reduced their borrowing for automobiles, other durables, and home improvements which were not covered. Thus, only a part of the \$8 billion decline in consumer instalment debt can be attributed directly to the consumer credit restraint program. Indirectly, however, the program did change the behavior of both borrowers and lenders and had an important psychological effect on household willingness to finance purchases with credit. At the same time, some lenders were finding consumer lending unprofitable. Since the cost of short-term funds was running well above the going rate for such loans (held back by usury ceilings in many states), lenders had an incentive to curtail their consumer loan business.

Nevertheless, it would be wrong to exaggerate the effects of the credit

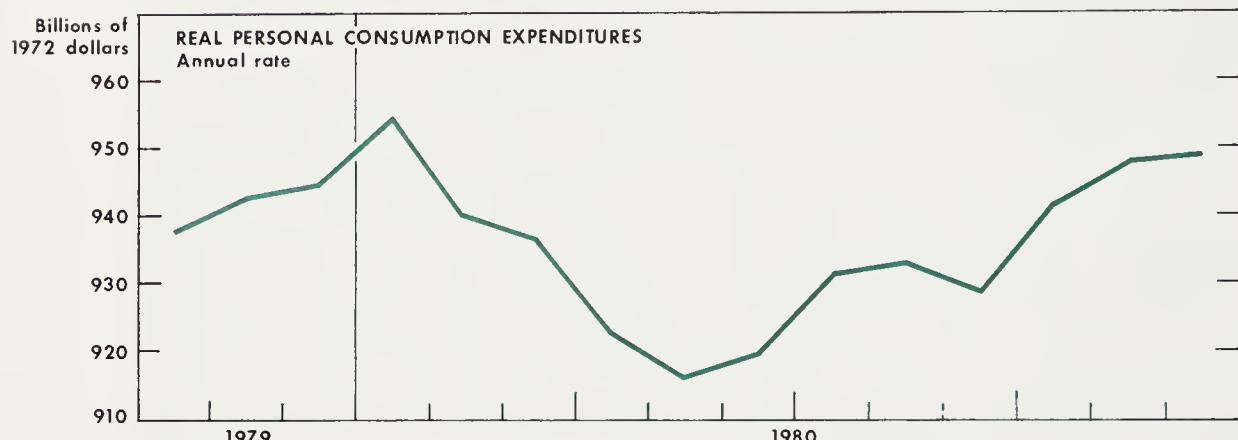
Chart 2. ECONOMIC ACTIVITY TURNED DOWN EARLY IN 1980 AND THEN REBOUNDED IN THE SECOND HALF OF THE YEAR.



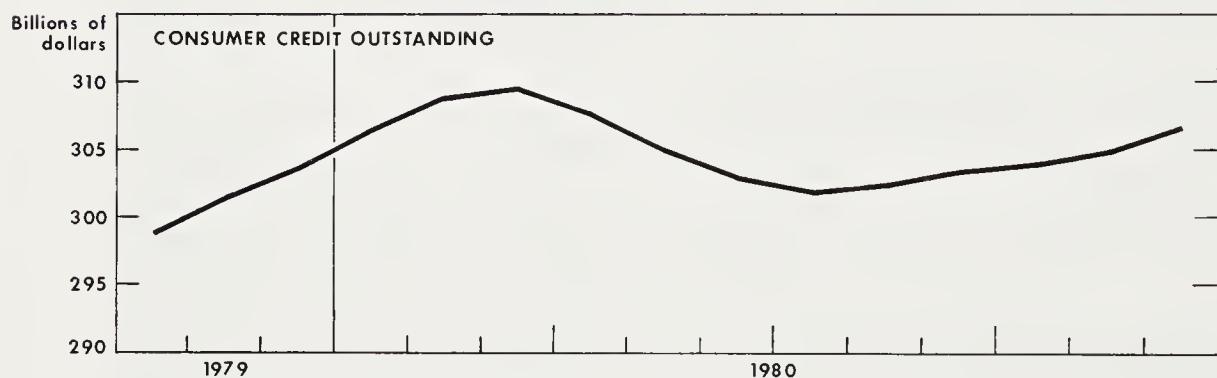
All data are seasonally adjusted.

restraint program in dampening consumption. Although on a quarterly basis the collapse in consumption spending appears to have coincided with the program, monthly data suggest that personal consumption spending had begun to decline in advance of the program. Indeed, real consumption spending peaked in January and was already 2 percent lower in March (Chart 3). Nor was the subsequent decline in consumption outlays from March until May any faster or sharper than the downslide in the earlier months. Most of the January-

Chart 3. CONSUMER EXPENDITURES DROPPED FROM JANUARY THROUGH MAY AND THEN RECOVERED.



CONSUMER INSTALMENT CREDIT REFLECTED THE SWINGS IN CONSUMPTION AND THE MARCH 14 CREDIT RESTRAINT PROGRAM.



All data are seasonally adjusted.

to-May decline in total consumption spending, moreover, was concentrated in purchases of motor vehicles and parts. Thus, it appears that recessionary forces were already at work before the special credit restraints were imposed.

Another major force in the downturn was residential construction. Major pieces of Federal legislation had the effect of preempting the usury ceilings on mortgage interest rates throughout the country unless individual states expressly declared otherwise. Despite the lifting of mortgage usury ceilings,

mortgage lending and home construction continued declining over the opening months of 1980. Then, as interest rates in general surged to record high levels, mortgage lending dried up almost completely, with the rate on new commitments climbing as high as 16 to 17 percent. Housing starts plunged. By May, housing starts were down to only 900,000 units at an annual rate, the lowest level since early 1975 when the economy was also enmeshed in a recession.

The 1980 recession turned out to be exceptionally brief, lasting but six months in all. Industrial production bottomed out in July at a level 8 percent below the cyclical peak recorded for the preceding January. Unemployment stood at 7.8 percent in July, up almost 2 percentage points from what it had been at the end of 1979. In view of the remarkably steep curtailment in the use of credit during the recession as well as the sharp fall in the monetary aggregates, the credit controls were loosened at the end of May and then phased out altogether in July.

THE UPTURN. With the slump in business activity, interest rates tumbled. The yield on three-month Treasury bills, for example, after peaking at 16 percent at the end of March, fell below 7 percent in June (Chart 4). Other short-term rates staged similarly spectacular declines. Long-term rates also dropped rapidly, though not by as much as short-term rates. As interest rates declined, the apprehension that had affected financial markets and institutions, businesses, and households subsided.

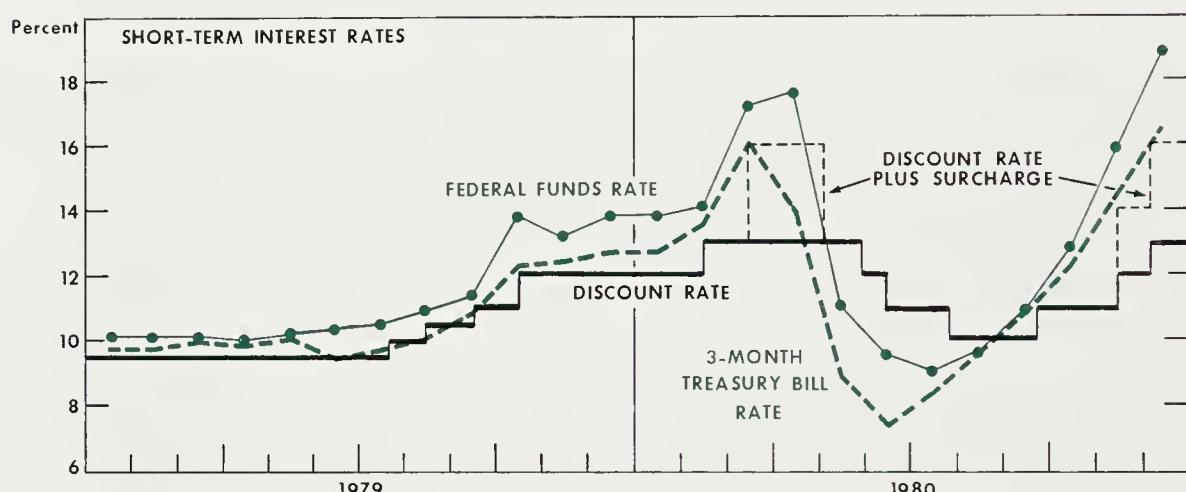
Thrift institutions became more willing to make mortgages. Indeed, they offered mortgages at rates close to 12 percent in July, compared with 17 percent in March. (This decline was much larger than the fall in rates on long-term securities.) With the decline in mortgage rates, activity in the housing market revived. Sales of new single-family houses jumped in July and August, and new home construction also swelled. Housing starts surged 26 percent in June, rising to 1.2 million units at an annual rate, and by October had surpassed 1½ million units.

Even more significant in the upturn was a sharp resurgence in consumer spending on goods and services. In real terms, consumption outlays bottomed out in May and then rebounded vigorously. This growth was concentrated in spending on durable goods. Domestic car sales reached an annual rate of 6.4 million units in July, up nearly 25 percent from the low in May. In the process, dealers' inventories of new domestic cars receded from the ex-

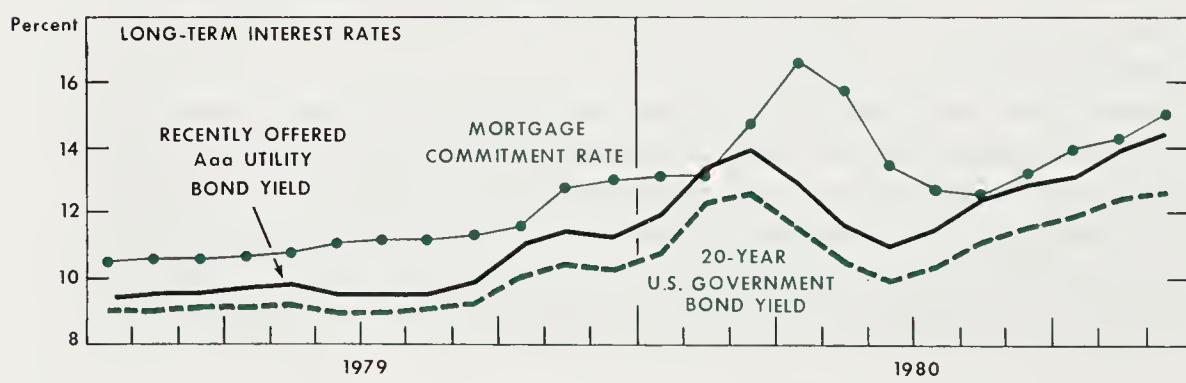
tremely high levels to which they had climbed in the spring. The economic expansion continued unfolding over the rest of the year, impelled largely by the momentum in nonautomotive consumption spending. Payroll employment increased by 1½ million jobs from July to December, and the unemployment rate declined almost ½ percentage point, closing out the year at 7.4 percent.

As the tempo of economic activity picked up, interest rates began to rise. The rise in rates was modest at first, but the pace quickened as the year wore on. In an effort to limit the excessive growth of money and credit, in mid-November the Federal Reserve raised the basic discount rate and imposed a

Chart 4. SHORT-TERM INTEREST RATES WERE HIGHLY VOLATILE IN 1980 . . .



. . . AND, AS EXPECTATIONS OF INFLATION AND THE STRENGTH OF THE ECONOMY CHANGED, LONG-TERM RATES ALSO VARIED WIDELY.



surcharge of 2 percentage points on certain discount window borrowings by large institutions. By late November, interest rates had surpassed the record highs attained earlier in the year and continued climbing to new records.

In the face of the rising interest rates, the pace of the upturn began to taper off toward the year-end. Housing starts, for instance, flattened out at an annual rate of about 1½ million units over the last few months of the year. Although single-family housing starts did decline, the construction of new multifamily units picked up, buoyed in part by the infusion of Federal funds. Also, new domestic car sales leveled off after July and were essentially flat throughout the rest of the year. Still, nonautomotive consumption spending spurted, and overall economic activity did continue to expand over the closing months of the year. By the end of 1980, industrial production had regained all but 1 percent of the loss sustained during the recession.

Even after yet another year of no economic growth, inflation stubbornly persisted. Much of the bulge in oil prices had worked its way through the industrial structure by mid-1980 so that there was some apparent relief in producer price increases. However, the underlying inflation rate, adjusted for biases and special factors, appeared to be running close to 10 percent. Unlike past inflationary episodes, wages and prices continued to grow at distressingly high rates despite the substantial slack in the economy. This time, decisions about wages and prices have come to be based on deeply embedded inflationary expectations conditioned by the rapid rates of inflation recorded in recent years. Altering these heightened expectations will take time as well as consistent and coordinated fiscal and monetary policies.

THE FINANCIAL MARKETS. It was a turbulent year for the financial markets. Twice during the year, interest rates rose to record levels—once at the beginning of the year and then again at the end (Chart 4). In addition, day-to-day variations in long-term interest rates were as large as 30 to 40 basis points (0.3 to 0.4 percentage point), whereas in earlier years a swing of even 10 basis points would have been regarded as uncommonly large.

Early in the year the rapid rise in rates was accompanied by severe strains. Indeed, from January to March, the bond markets almost came to a standstill as investors, alarmed by the sudden flare-up in inflation, abandoned the market. During this same period, the life insurance companies became increasingly disturbed by the precipitous decline in their cash flow and the massive

reduction of the value of the assets in their portfolios. And thrift institutions, distressed because their marginal cost of funds had risen so much and fearful that large-scale deposit withdrawals were in the offing, hiked mortgage rates to levels designed to discourage almost all potential borrowers. In the spring and early summer, interest rates fell sharply and the strains on the financial markets eased considerably. Participants in the financial markets, observing how quickly conditions could change, adapted their positions and expectations accordingly. Indeed, when rates rose sharply for a second time later in the year, there was much less apprehension and worry.

Reflecting the sharp fluctuations in interest rates, the volume of monthly corporate bond issues in 1980 ranged from very low to record high levels. For the year as a whole, a record \$52½ billion in gross corporate bonds was either privately placed or sold in the public market, compared with \$40 billion in 1979. Early in the year, as the alarm in this market grew, new issues tapered off to a trickle. However, as rates declined in the late spring and early summer, corporations marketed record volumes of new bond issues, averaging nearly \$7½ billion per month in May, June, and July. Then, as long-term rates began rising, many corporations delayed their issuance of new long-term bonds. Instead, borrowers turned to commercial banks for funds, and business loans boomed. From July to December, business loans (including loans sold to affiliates but excluding bankers' acceptances) increased almost \$29 billion, whereas they had actually slipped a bit from January to July.

The sharp upward sweeps in interest rates during 1980 had a wrenching effect upon the thrift institutions. Unlike commercial banks, thrift institutions have not been able to develop a close match between the interest rates they earn on their assets and those they pay for their funds, and as a result their profits were unfavorably affected by the run-up in rates. By the end of 1980, roughly 40 percent of the total liabilities of the thrift institutions was made up of rate-sensitive money market certificates, first authorized with a six-month maturity and minimum denomination of \$10,000 in 1978 and with a thirty-month maturity in 1980. In contrast, most of their assets are long-term, fixed-rate mortgages with a majority of them issued years earlier when interest rates were much lower.

In 1980, mortgage lenders increasingly sought to change their lending operations to reduce their interest rate vulnerability. Mortgage rates now tend to be set at the time of closing instead of commitment, and large nonrefundable commitment fees are imposed to discourage borrowers from canceling in the

event that rates decline. Lenders also increasingly rely on the secondary mortgage markets. The ratio of mortgage resales in the secondary markets to originations in 1980 was nearly double what it had been in 1978.

The thrift institutions have issued an increasingly larger proportion of flexible rate mortgages. By the end of 1980, flexible rate mortgages accounted for almost 6 percent of their total outstanding mortgages. Of the several different kinds of flexible rate mortgages, the two most popular instruments were the variable rate mortgage and the renegotiable rate mortgage. For variable rate mortgages, the interest rate can be changed within specified limits every six months. For renegotiable rate mortgages, the interest rate becomes subject to renegotiation and can be changed within specified limits every three to five years. There was also some experimentation with other types of mortgages. A few lenders, for example, have issued the so-called shared-appreciation mortgages, but these have not yet been approved by the Federal Home Loan Bank Board for use by Federally chartered thrift institutions.

Pinched severely by the high interest rates recorded in 1980, the life insurance companies also sought ways to change their investment policies in order to reduce their vulnerability. More and more of the commercial mortgages that these companies are adding to their portfolios involve a flexible rate related to the prime rate or some other independent index, income participation in the properties, or call provisions entitling them to call back the loan before it matures and renegotiate the interest rate. There have been similar changes in their investments in directly placed corporate bonds. Increasingly, these bonds include a floating rate; income-participation features, such as warrants; and much shorter maturities than those prevailing in the past.

By the end of the year, the thrift institutions and insurance companies had made some progress toward allaying their vulnerability to high interest rates. Still, the process was far from complete, and many of the thrift institutions sustained large losses during 1980. In a few cases, the losses were so large that an institution's net worth was totally exhausted. Unless there is relief soon from these high interest rates, many other thrift institutions will also be threatened with financial insolvency, creating additional strains on the financial system. This possibility makes the current anti-inflation effort all the more imperative. Only to the extent that inflation is permanently dampened will there be a sustainable decline in interest rates.

Monetary Policy

Monetary policy faced a difficult course in 1980. Turbulent swings in economic activity and financial conditions marked the year and greatly complicated the execution of policy. As the pace of business and financial flows plunged and then recovered, both the money stock and the level of interest rates showed large fluctuations. Despite much short-run variability, however, growth of the narrow aggregates for the year as a whole (after adjustment for the more rapid than expected growth of interest-bearing checkable deposits) was close to the upper limits of the Federal Reserve's annual target ranges, while the broader money measures exceeded their top limits by a small margin. Bank credit growth was well within its target range for the year (table).

The basic goal of monetary policy—to reduce inflation by gradually lowering money growth—did not change in 1980. In pursuit of this goal, the Federal Reserve continued to use a new operating procedure begun in October 1979 that places more weight on controlling the supply of bank reserves and less on limiting short-run movements in the Federal funds rate. At the same time, the Reserve System formulated its annual targets in terms of new monetary aggregates designed to reflect financial innovation and regulatory changes in a better way.

In recent years, new types of deposits and market instruments have developed. The monetary aggregates were redefined to account for these changes and to combine in a consistent way liabilities issued by all depository institutions.

**GROWTH RATES AND TARGET RANGES FOR THE AGGREGATES
FOURTH QUARTER TO FOURTH QUARTER (in percent)**

| Aggregates | 1980 annual target ranges | Annual growth rates | 1981 annual target ranges |
|-------------------|---------------------------|---------------------|---------------------------|
| M-1A | 3.5–6.0 | 5.0 (6.3)* | 3.0–5.5† |
| M-1B | 4.0–6.5 | 7.3 (6.7)* | 3.5–6.0† |
| M-2 | 6.0–9.0 | 9.8 | 6.0–9.0 |
| M-3 | 6.5–9.5 | 9.9 | 6.5–9.5 |
| Bank credit | 6.0–9.0 | 7.9 | 6.0–9.0 |

* Adjusted for the more rapid than expected growth of ATS accounts in 1980. This adjustment assumes that two thirds of the unexpected growth of other checkable deposits during 1980 resulted from shifts of funds out of demand deposits and one third from shifts out of savings accounts.

† After adjusting for the effects of nationwide NOW accounts.

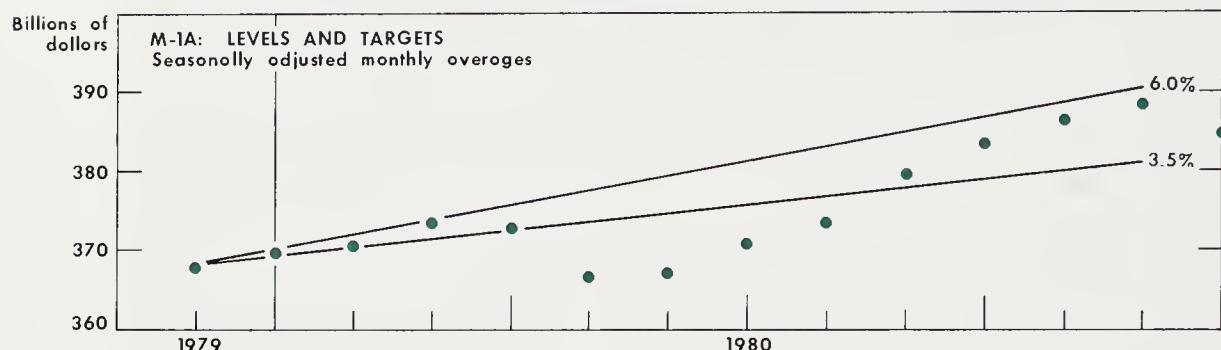
The major new transactions aggregate, M-1B, contains currency plus all "checkable deposits"—including those that pay interest—at both banks and thrift institutions. M-1A, which is similar to the old M-1 concept, does not contain other checkable deposits such as ATS (automatic transfer service) and NOW (negotiable order of withdrawal) accounts. For the broader measures, new M-2 adds to M-1B savings and small time deposits at all institutions. Furthermore, it contains a number of liquid market instruments that serve some of the functions of money: money market mutual funds shares, overnight repurchase agreements (RPs), and overnight Eurodollars. The second broad target aggregate, M-3, consists of M-2 plus large time deposits and term RPs. While the new definitions attempt to allow for recent market innovations and regulatory changes in a consistent manner, further evolution of market practices could well make necessary a future review of the definitions.

THE BEHAVIOR OF THE AGGREGATES. For the year as a whole the monetary aggregates increased at rates near the upper bounds of the annual ranges. But money growth was very erratic within the year, reflecting in part unusually sharp swings in the pace of economic activity. The extent of the movements in money growth, however, was greater than what could be accounted for by the business cycle alone. Thus, for example, the decline in the money stock in the second quarter appears to have been sharper than what can be explained by the concomitant drop in economic activity or by a lagged reaction to record high interest rates in the first quarter. The combination of shifts in expectations about inflation, the imposition and removal of the special credit restraint measures, and the unusually sharp swings in interest rates aggravated oscillations in the demand for money.

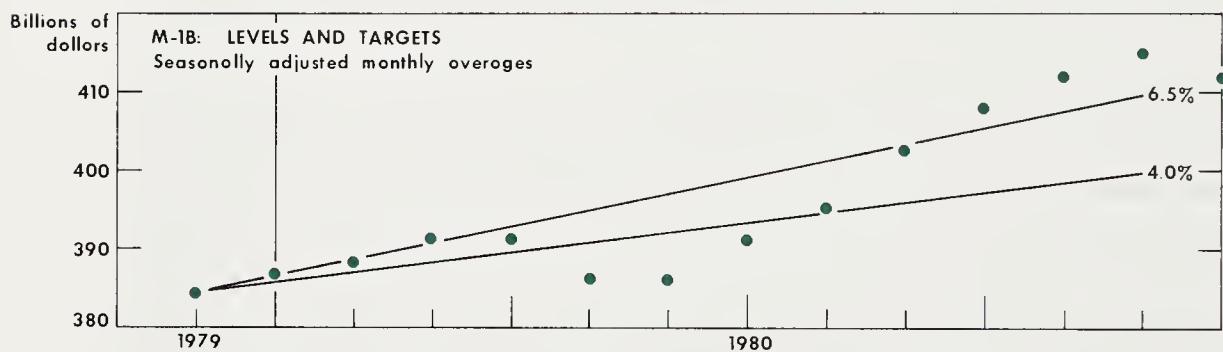
Coming into the year, the monetary aggregates continued their modest expansion of late 1979. Soon, however, strains appeared in the financial markets. Inflationary expectations accelerated strongly and business loans resumed rapid growth. In this atmosphere of inflationary credit demand, market rates moved sharply higher.

In March, the establishment of the credit restraint program precipitated a sharp decline in credit demand. As businesses and consumers repaid bank loans, the rate of bank credit growth slowed abruptly and turned negative. The high level of market interest rates, the recession, and the contraction of financial flows combined to curtail the growth of money demand. The narrow aggregates, in

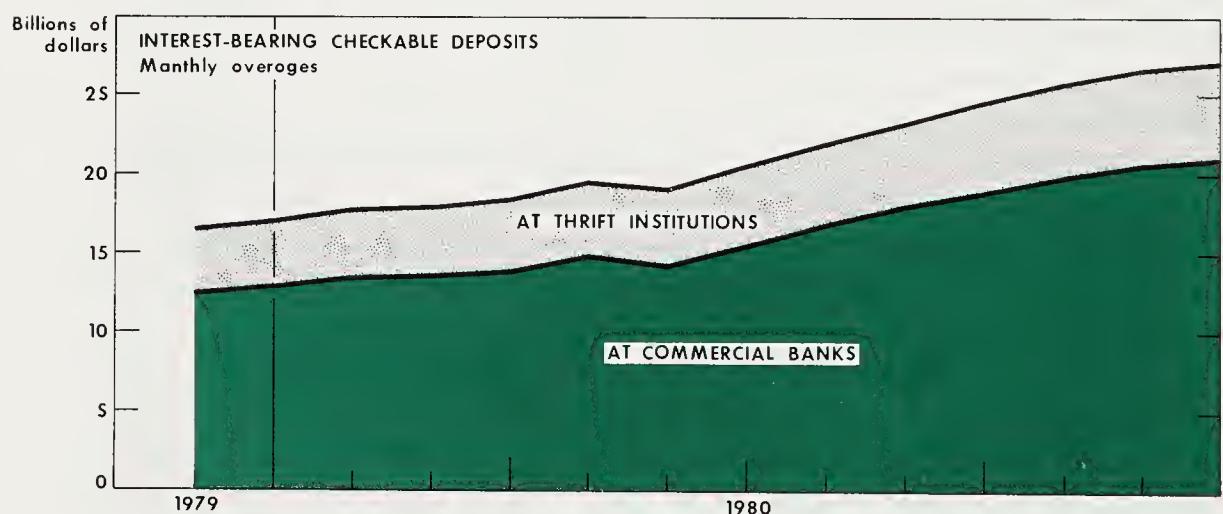
Chart 5. BOTH NARROW AGGREGATES SHOWED WIDE SWINGS DURING 1980, BUT M-1A FINISHED THE YEAR WELL WITHIN ITS TARGET RANGE . . .



. . . WHILE M-1B SLIGHTLY EXCEEDED ITS UPPER LIMIT . . .



. . . REFLECTING FASTER THAN EXPECTED GROWTH OF ATS ACCOUNTS
AT COMMERCIAL BANKS.



fact, fell precipitously in April and remained weak until midsummer. Over this period, interest rates fell even more quickly than they had climbed.

With the resurgence of the economy and the phasing-out of the credit restraint program in July, both business and consumer credit demands revived and the monetary aggregates began to grow faster. In fact, by the autumn they were growing more quickly than expected on the basis of established relationships to income and interest rates, partially offsetting their abnormal weakness in the spring.

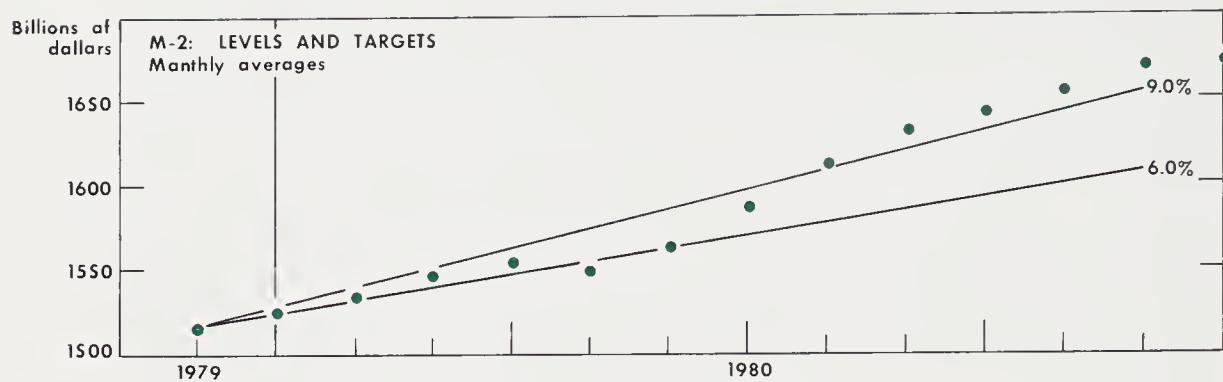
Money continued to grow rapidly through the autumn as business activity and credit demand strengthened further. By the beginning of the fourth quarter, M-1B and the broad monetary aggregates were at or above the top of their target ranges. But market rates were again in a strong steady climb, reaching levels in early December above their March peaks. As 1980 ended, money growth began to slow. For the year, M-1A finished well inside its range, while M-1B exceeded its target (Chart 5).

The disparity between the growth rates of the two narrow aggregates resulted from the rapid growth of ATS accounts. In the second half of 1980, commercial banks aggressively promoted these accounts to solidify their market share in advance of the January 1, 1981 date on which nationwide NOW accounts would be permitted. As the public shifted funds from demand deposits to other checkable deposits, growth of M-1A slowed. Although this shift did not affect M-1B, funds from savings accounts were also moved into ATS accounts, raising M-1B growth and widening the spread between the growth rates of the narrow aggregates. The M-1A and M-1B targets for 1980 were set with only a $\frac{1}{2}$ percentage point spread because a relatively small growth of interest-bearing checkable deposits was anticipated prior to the authorization of nationwide NOW accounts. Reflecting the more rapid than expected ATS growth, M-1B actually increased about $2\frac{1}{4}$ percentage points faster than M-1A. Adjusted for the rapid increase of ATS accounts, however, both M-1A and M-1B showed annual growth rates about equal to the upper limits of the Reserve System's ranges (table).

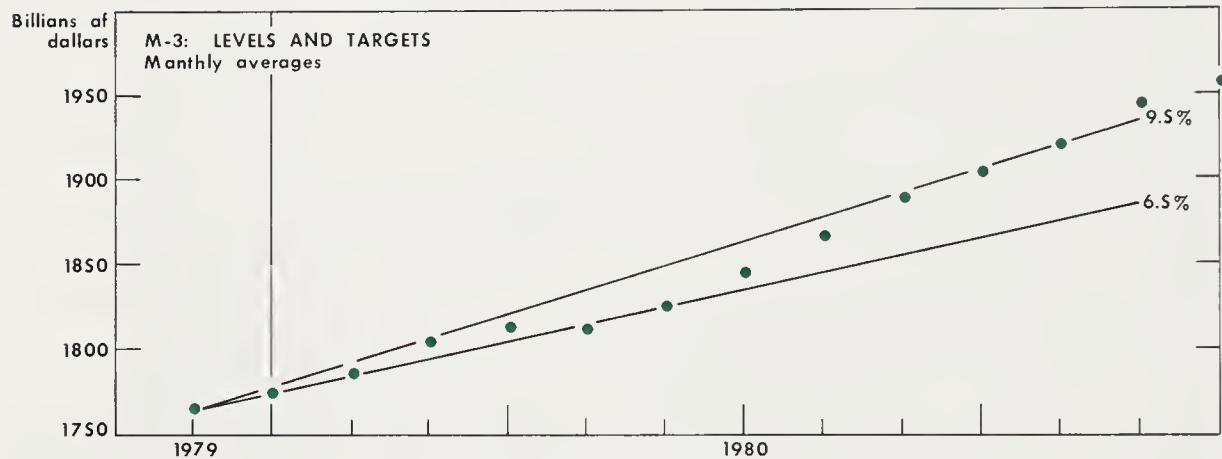
Over the course of the year, the broad money measures were much less variable than M-1A and M-1B. Thus, M-2 and M-3 declined only slightly and temporarily in April. They also grew rapidly in late summer and autumn but showed little of the slowdown late in the year that characterized the narrow aggregates. Both broad measures finished the year somewhat above their target ranges (Chart 6).

For 1981, the System, in line with the long-run objective of reducing in-

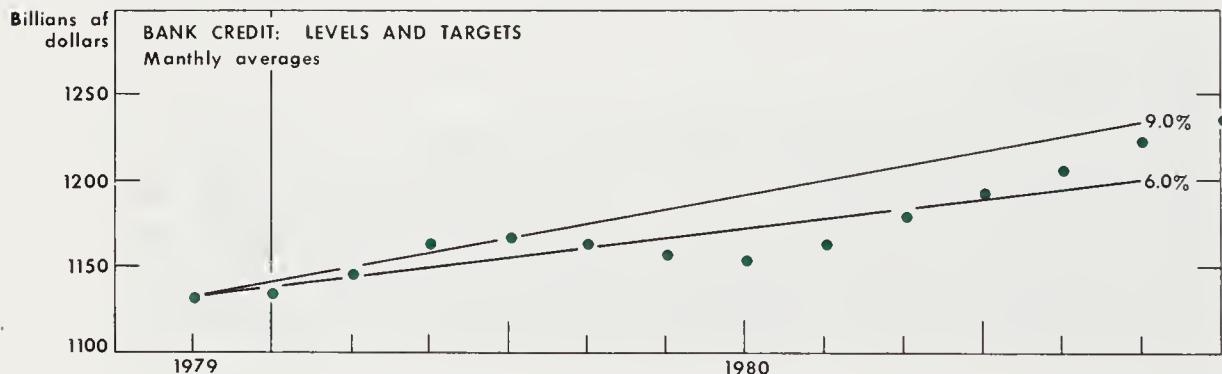
**Chart 6. THE BROADER MONETARY AGGREGATES WERE LESS VARIABLE
OVER THE YEAR . . .**



. . . AND FINISHED SOMEWHAT ABOVE THEIR ANNUAL TARGETS . . .



. . . BUT BANK CREDIT SHOWED LARGE SWINGS AND ENDED
THE YEAR INSIDE ITS RANGE.



All data are seasonally adjusted.

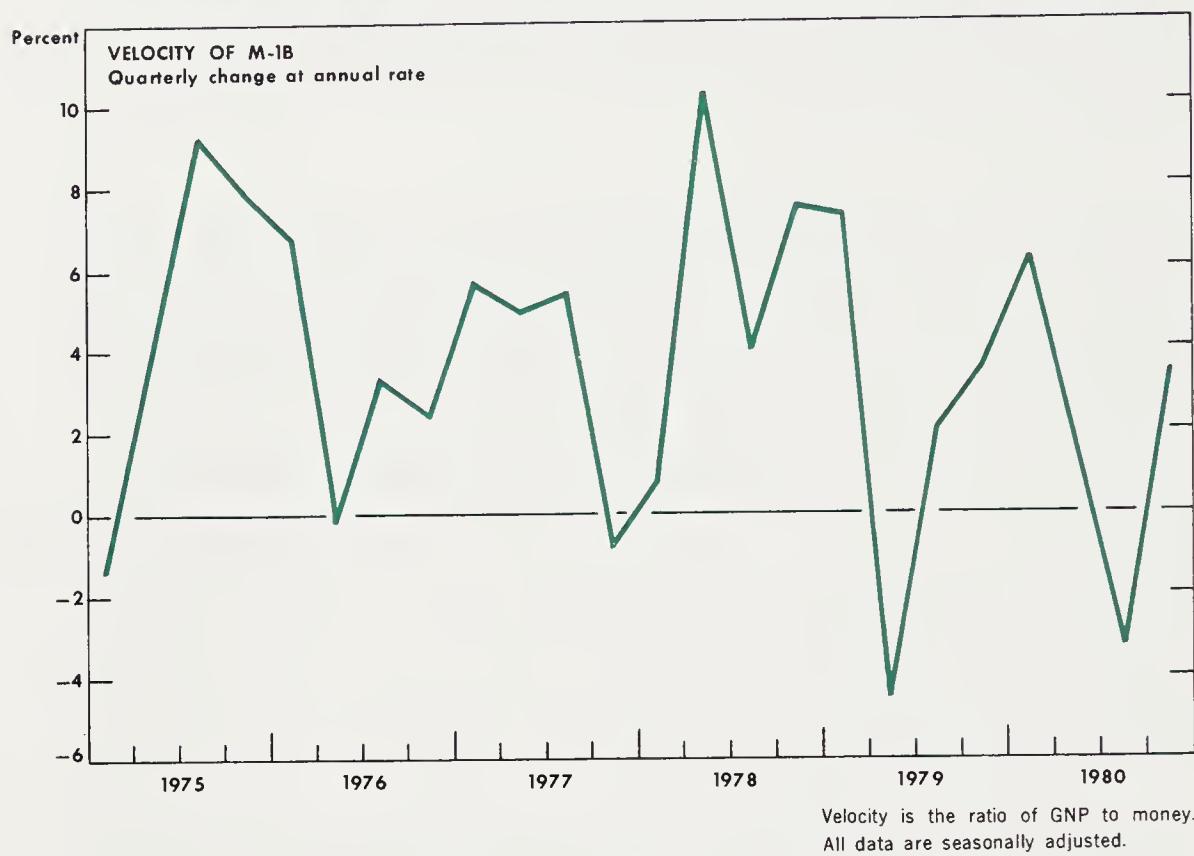
flation, set targets for the narrow monetary aggregates $\frac{1}{2}$ percentage point lower than those for 1980 (after adjustment for the effects of nationwide NOW accounts), while keeping the target ranges for the broad monetary aggregates and for bank credit unchanged.

APPRAISING THE NEW APPROACH. As noted, the Federal Reserve continued to implement policy under the new operating procedure that emphasizes control of the supply of bank reserves rather than the Federal funds rate. In outline, it works as follows. The Federal Open Market Committee (FOMC) sets up short-run paths for the aggregates that accord with the annual targets. Given the short-run money objective, associated paths for total and nonborrowed reserves are constructed that take into account expected shifts in the public's demand for currency, the composition of bank liabilities with different reserve requirements, expected bank borrowings at the discount window, and other factors affecting the relation between nonborrowed reserves and money. The Trading Desk then supplies nonborrowed reserves consistent with this objective. Thus, if the demand for money and required reserves is running high (low) relative to the FOMC's targets, nonborrowed reserves will be in short (excess) supply. This will, in turn, put upward (downward) pressure on short-term interest rates. In this way, pressures are generated that tend to curb the overshooting (undershooting) of money growth relative to the short-term objectives.

For 1980 as a whole, monetary expansion was not far out of line with the targets for the year, but money growth was highly variable from month to month and the wide movements in interest rates were unprecedented. The broad swings in money and interest rates to a large extent reflected the unusual economic circumstances during the year.

The fluctuations in money growth that occurred have led some observers to suggest that the procedure used to implement the money targets should be changed. However, the new approach was not intended to control short-run aggregates growth rigidly. There is little evidence that tighter month-to-month (or even quarter-to-quarter) control of money growth would result in a smoother course for income growth since, even on a quarterly basis, the relationship of money to GNP has been unstable and unpredictable (Chart 7). To the contrary, attempting stricter short-run money control in the face of fluctuating demands might only result in more variability in interest rates and, in turn, in real output.

Chart 7. QUARTERLY CHANGES IN THE VELOCITY OF MONEY CONTINUED TO BE ERRATIC IN 1980.



The new procedure was set up instead to ensure that policy would operate to achieve long-run money growth consistent with a reduction of inflation. From this view, policy worked well last year. Although the monetary aggregates other than M-1A came in slightly above target for the year, this reflected the acceleration of their growth after midyear, too late for the full response of money growth to reduced reserve availability to appear by the end of 1980. On balance, the new procedure did operate effectively to restrain monetary expansion.

Although 1980 was a difficult year for which to sort out causes and effects, the Federal Reserve has evaluated the experience with the new approach to determine whether certain refinements could improve overall performance. Some steps are being considered with an eye toward their possible advantages

in terms of more effective and timely monetary control. The principal questions being examined are whether a switch to contemporaneous reserve accounting would improve the control of money through reserves and whether other ways of setting the discount rate or administering the discount window would increase the Trading Desk's ability to control the monetary aggregates.

Fundamentally, more stable money growth on a short-run basis would appear to require extreme swings in short-term interest rates. Research studies of monetary developments in 1980 offer some support to the claim that even greater interest rate changes than occurred last year could have dampened the fluctuations of the aggregates. The reduction of variability would have been small, however, relative to the changes in the aggregates that actually took place. Looking at all the evidence, there is little reason to believe that single-minded control of money growth on a monthly or quarterly basis is an appropriate monetary policy.

International Developments

Controlling inflation was the overriding objective of the major foreign industrial countries during 1980. They all had to deal with the consequences of the second round of oil price hikes that had built up over the previous year. These price hikes raised inflation rates throughout the world. By increasing oil-import bills, they also worsened current account positions. Simultaneously, many countries experienced inflationary consequences from fairly brisk levels of economic activity and the beginning of some pressures on industrial capacity. The concern was that these developments would set off a wage-price spiral and push inflation up even further. To contain these inflationary pressures, authorities in all the major countries were directing their economic policies toward restraint. This meant limited money and credit growth, relatively high interest rates, and broadly nonexpansionary fiscal policies.

The immediate impact of these policies differed widely across countries. By the end of the year, some countries were left with sustained or moderately higher inflation rates while others recorded substantial reductions from earlier peaks. Current account positions improved considerably in some countries, but deficits widened in others. Similarly, there were also wide swings in exchange rates and consequently in international competitive positions.

What was common, by contrast, was a sharp decline in growth most everywhere beginning in the second quarter. The falloff was led by a slowdown in domestic demand, combined in some countries with weak export performance. With growth rates falling, unemployment for some began to move markedly upward by late summer.

At the outset of the year, few major countries questioned the need for a restrictive policy stance to get inflation under control. But, by the end of the year, a number of countries were finding it increasingly difficult to reconcile growth and employment objectives with the continuing aim of lowering inflation. Any case for stimulating the economies abroad could run up against the problem of worsening inflationary expectations and, therefore, compounding the difficulty of achieving either lower inflation or sustained economic growth.

Diversity in response to the effects of the second energy shock was also mirrored in the developing countries during 1980. While most oil producers faced generally smooth sailing, those dependent on oil imports fared less well. On top of higher oil-import bills, many nonoil less developed countries (LDCs) found the growth of their export volume slacken because of weakening demand

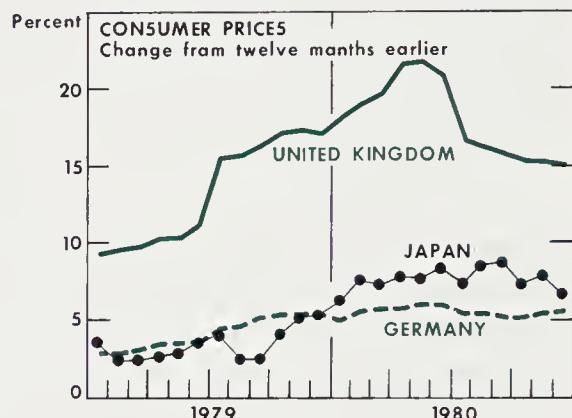
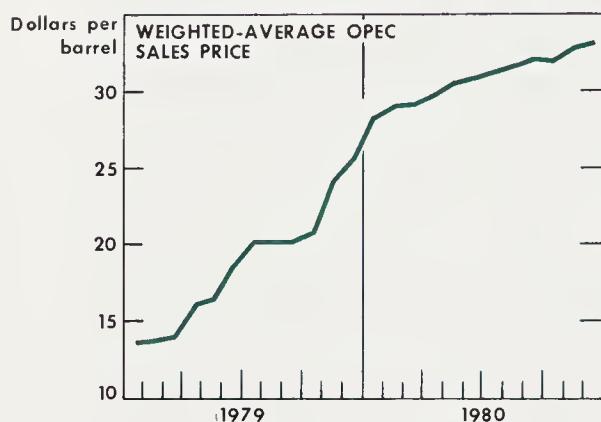
in the industrial countries. Disparate movements in prices of specific commodities also had an uneven impact on many of these countries. In addition, high levels of interest rates worldwide added to debt service costs. The question of adequate financing for current account deficits became increasingly important during the year.

THE MAJOR INDUSTRIAL COUNTRIES. As 1980 got under way, there was widespread agreement among the major countries on the direction for economic policy. Broadly restrictive monetary policies with associated high interest rates, together with nonexpansionary fiscal policies, were pursued to prevent sharply higher energy prices from setting off an inflationary spiral. The need for restraint had become apparent as early as mid-1979, once the full dimensions of the wave of oil price increases that started at the end of 1978 were recognized. Oil prices rose by about 140 percent between the end of 1978 and the end of 1980 (Chart 8). In contrast to the period following the first oil shock in 1973-74, most of the major economies allowed the oil price increases to be passed through to domestic prices. As a consequence, over the course of 1979 and 1980, the direct effects of the oil price hikes raised domestic consumer prices for the major industrial economies on average by an estimated 4 to 5 percentage points, while the indirect effects added a few more percentage points.

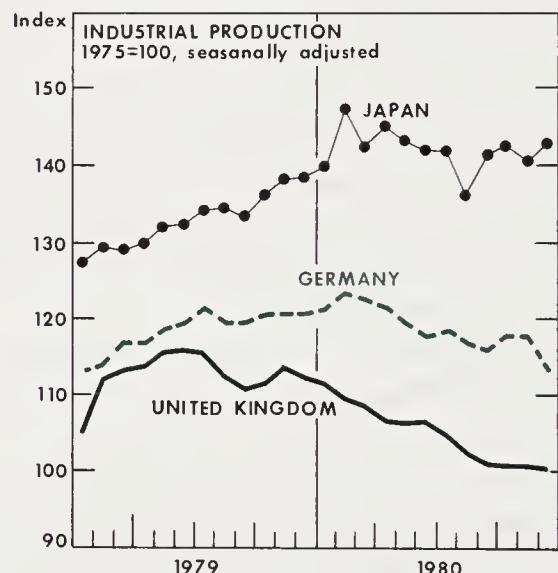
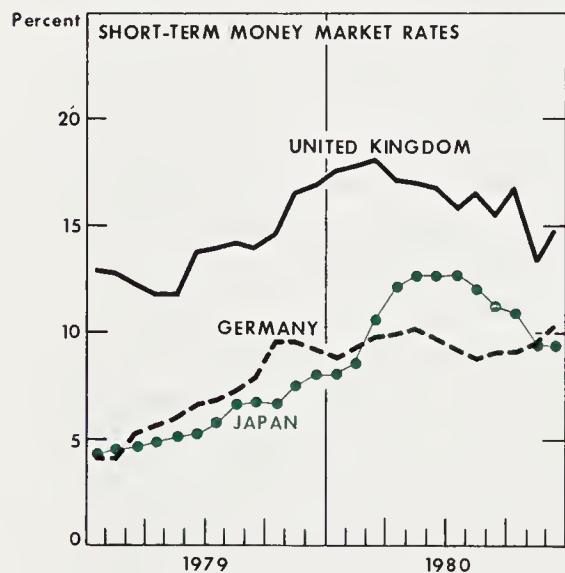
This inflationary impulse was aggravated in many of the foreign economies by the effects of robust levels of economic activity in early 1980. Some of these economies were growing rapidly at this time and nearing high levels of resource utilization. Germany, Japan, and Italy had especially strong expansions. Of the major foreign countries, only the United Kingdom and Canada were experiencing declines in early 1980.

Restrictive policies were also desired for external reasons. Most foreign economies had to finance widening current account deficits. High interest rates could attract capital inflows and offset expected current account deficits. High interest rates would also tend to strengthen the currency. This could ease domestic inflationary pressures by holding down import costs. But here the risk was that the competitiveness of a country's exports would be undermined over the longer term. Moreover, while an individual country might seek some external benefits from a restrictive policy, all countries could not simultaneously improve their situation by this means.

Chart 8. OIL PRICE INCREASES ADDED TO INFLATION IN EARLY 1980 . . .



. . . PROMPTING A RESTRICTIVE POLICY STANCE ABROAD AND A SLOWDOWN IN GROWTH.



ECONOMIC ACTIVITY. In early 1980, the prevailing view was that there was sufficient strength in some of the major economies to prevent a synchronized decline in growth abroad, despite the slowdown in the United States. In fact, this did not turn out to be true. Beginning in the second quarter, all the foreign industrial economies, with the exception of Japan, suffered sharp falloffs in

economie activity. Overall growth for the year is estimated to have been on average about 2.5 percent for these economies, down substantially from the 4.4 percent rate recorded in 1979.

In the United Kingdom, the decline proved far steeper than had been expected, with no evidence at the end of the year that the recession had bottomed out. In Germany, surprisingly strong growth in the first quarter was followed by a broadly based decline for the rest of the year. Japan was the only major country to show significant growth in 1980. Yet, despite overall growth of around 5.5 percent, domestic demand was relatively weak throughout much of the year, rising by no more than about 2 percent.

One feature of the slowdown that was common to most countries in North America and Europe was a decline in car production, roughly 24 percent in the United States and about 8 percent in Europe. The only major countries increasing production in 1980 were Japan and Italy. For Japan, this was largely because of a favorable exchange rate early in the year, rapid productivity gains, and the ability to deliver fuel-efficient cars. Another common feature of the slowdown was the sharp falloff in housing and nonresidential construction. The declines were particularly steep in the United Kingdom.

The tendency of unemployment to be a lagging indicator of decline was underscored by the experiences in 1980. Unemployment did not increase immediately as industrial production fell. But, when unemployment began to rise, especially as in the United Kingdom, it did so at a rapid pace. By December, it was approaching 9 percent in the United Kingdom, over 3 percentage points higher than the year before, and was near 8 percent in Canada and Italy. Germany also began to register increases in unemployment by the end of the year, with the rate rising by about 1 percentage point over the course of 1980.

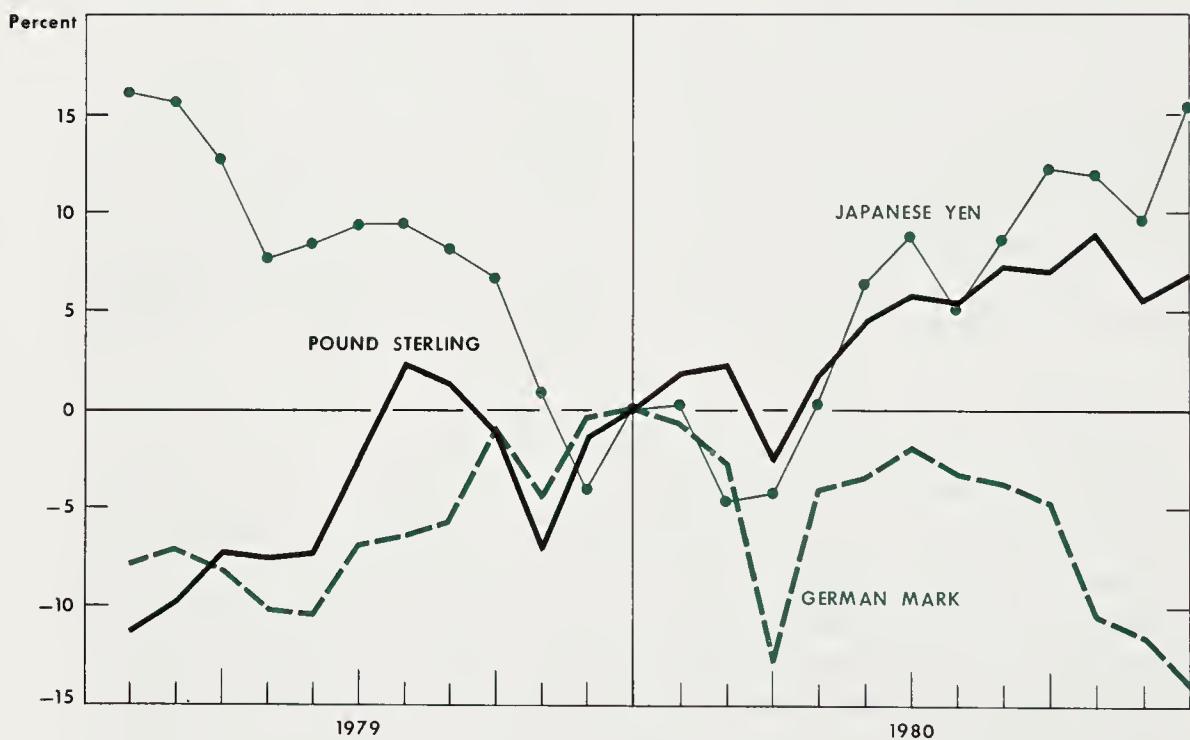
MONETARY POLICY AND EXCHANGE RATES. Most of the major foreign countries had chosen to reduce their targets for money supply growth for 1980, compared with 1979. And there was some success in achieving the targeted aggregates or forecast levels. The major exception was the United Kingdom where the targeted aggregate of sterling M-3 (currency plus sterling demand and time deposits of United Kingdom residents) increased substantially, but growth of other nontargeted aggregates, notably M-1, was very slow.

One of the clearest signs of the restrictiveness of monetary policy abroad during the year was that nominal interest rates rose substantially more than

the rates of consumer price increases for most countries. Nominal interest rates abroad began to move sharply upward in early February. There was some easing toward early summer but, from the autumn on, short-term interest rate levels abroad firmed in Germany and were essentially unchanged in France and Italy. They eased moderately in Japan and the United Kingdom. Swings in interest rates abroad were generally less pronounced than those observed in the United States.

Interest rate movements in the United States, relative to those abroad, contributed to wide swings in exchange rate relationships among the major cur-

Chart 9. ALL THE MAJOR CURRENCIES DECLINED AGAINST THE DOLLAR EARLY IN THE YEAR, BUT ROSE TOWARD SPRING AS UNITED STATES INTEREST RATES PLUMMETED. THE GERMAN MARK WEAKENED FROM THE SUMMER ON, BUT THE POUND STERLING AND JAPANESE YEN REMAINED STRONG.



End-of-month rates, computed as percentage deviation from end-1979 rates.

rencies in 1980 (Chart 9). Thus, for example, the German mark was strong against the dollar early in the year, but began falling sharply toward spring as interest rates in the United States rose. It firmed against the dollar in late spring and early summer, when United States interest rates plummeted, but began falling toward late summer as interest rates here turned up again and expectations for an early improvement in the German current account evaporated. The Japanese yen was also weak against the dollar in early 1980 with high interest rates here, but firmed in midyear, and remained strong for the rest of the year, as Japan's current account deficit narrowed and the country recorded a relatively good economic performance. By the end of 1980, there was about a 25 percent appreciation of the Japanese yen against the German mark.

While interest rate differentials were important in influencing exchange rate changes in 1980, they could not account entirely for the changes which took place. For example, the interest rate differential between the dollar and the German mark prevailing in March 1980 also prevailed roughly in December 1980. Yet the dollar was about 5 percent higher against the German mark in December than it was in March. Even more to the point, movements in the interest rate differential between the dollar and the Japanese yen had little to do with the strong appreciation of the yen against the dollar after the middle of 1980. For, over this period, the interest rate differential in short-term money market rates began to move sharply in favor of the dollar, but the yen rose by almost 11 percent against the dollar from early August to the end of December.

The influence of inflation rate differentials on exchange rates in 1980 was also hard to detect. This was notably so for Germany, where an impressive relative inflation performance during the year failed to arrest the sharp depreciation of the German mark against the dollar and the Japanese yen. For the German mark, the large and unaccustomed current account deficit seems to have exerted a major influence on exchange rate performance.

EXTERNAL PERFORMANCE. All the foreign industrial economies, except the United Kingdom, faced widening current account deficits coming into 1980 (Chart 10). This was due largely to the increased prices for imported oil. In Germany, a weakening in export volume and the jump in oil prices helped increase the country's current account deficit to its highest level ever, about \$15 billion for the year. In France, a current account deficit of about \$7 billion for 1980 reversed a small surplus for 1979, primarily as a result of higher costs for

energy imports. Strong exports of agricultural goods, services, and military-related items offset a deterioration in industrial exports stemming from a firm currency and high inflation. And in Italy, government measures to sustain the lira in the European Monetary System despite a high inflation rate weakened the country's international competitiveness and led to a substantial decline in export volume. This falloff in exports contributed significantly to the \$15 billion swing in the Italian current account balance in 1980 to a \$10 billion deficit.

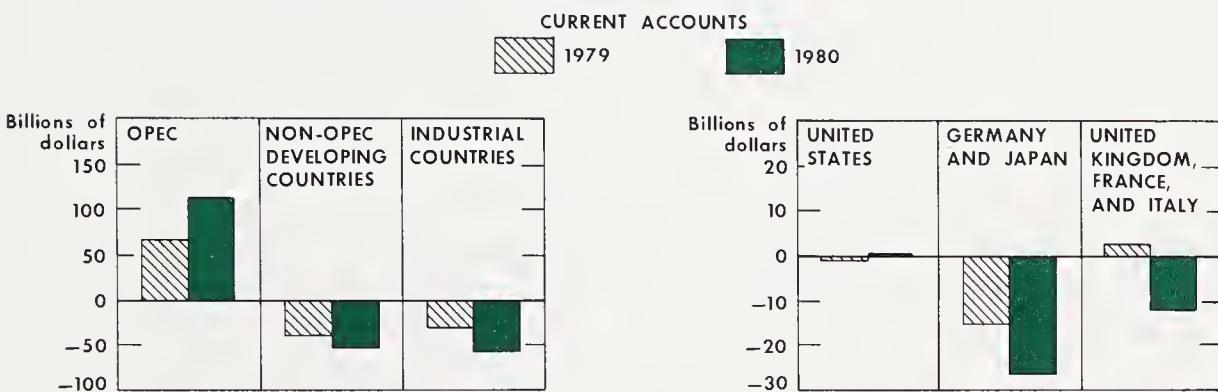
Japan managed to start improving its situation over the course of 1980, achieving virtual current account balance by the year-end, even though the deficit for the year was \$11 billion. The improvement was due primarily to sharply increased exports, which rose by almost 19 percent in volume. The lagged effects of a substantial depreciation of the Japanese yen in 1979 contributed to the strength of Japanese exports. The improvement in the country's current account deficit was also due to a leveling-off in import volume as a result of slower growth and, even more importantly, of energy conservation efforts.

Only two countries, the United Kingdom and the United States, were able to register current account surpluses in 1980. In the United Kingdom, the surplus totaled about \$5 billion. The slowdown in domestic economic activity helped depress import volume substantially, despite a strong currency. In addition, the achievement of a net surplus in the oil balance contributed to reversing earlier deficits.

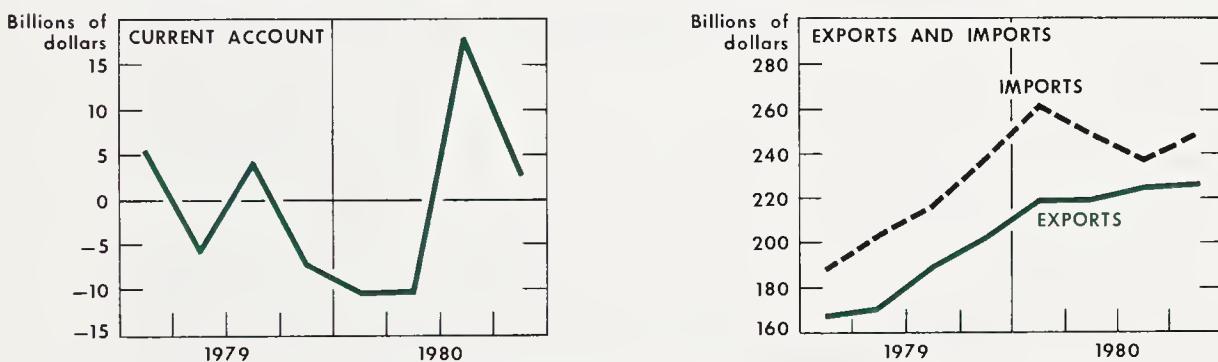
The United States current account was about in balance in 1980. Quarter by quarter, the current account was erratic, due to special transactions on investment income. Import volume fell by the middle of the year with the drop in domestic economic activity, and export volume tapered off in the latter part of the year with the slowdown abroad. Despite this slowdown, the volume of nonagricultural exports held up fairly well, rising by almost 3 percent from the fourth quarter of 1979 to the fourth quarter of 1980. Another important contribution to the current account surplus in this country was the impressive reduction of oil-import volume. This fell by over 25 percent from the fourth quarter of 1979 to the fourth quarter of 1980, even though real GNP was about the same in both periods.

Most of the other major countries also recorded substantial progress in oil conservation and oil-import reduction in 1980. Worldwide conservation efforts helped the oil markets withstand the war in the Middle East in the latter part of 1980. While there was some run-up in oil prices, this appeared rather modest in view of the considerable loss in output. Although the war produced a shock

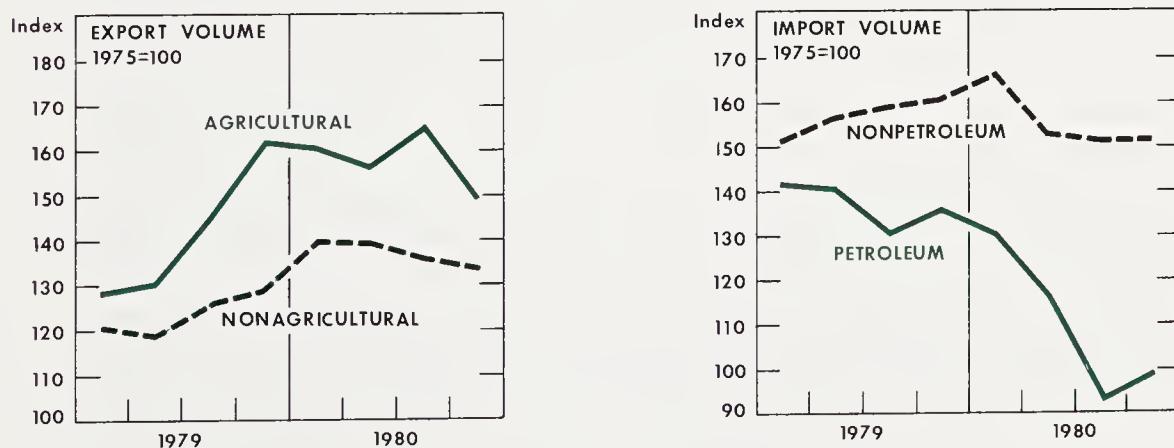
Chart 10. THE RISE IN OPEC OIL PRICES CAUSED A FURTHER DETERIORATION IN THE PATTERN OF WORLD PAYMENTS IN 1980 . . .



. . . BUT THE UNITED STATES ACCOUNTS STRENGTHENED AS EXPORT GROWTH CONTINUED AND IMPORTS DECLINED.



UNITED STATES EXPORT VOLUME HELD UP WELL DESPITE THE SLOWDOWN ABROAD, AND IMPORT VOLUME DROPPED OFF.



All United States data are at seasonally adjusted annual rates.

effect on supplies, it did not lead to another round of stockpiling. This reflected the basic weakness in demand and the large size of oil stockpiles. It also reflected a greater appreciation of a need to forestall another round of speculative stockpiling that might have generated greater pressures on prices.

INFLATION. Inflation performances among foreign economies varied greatly during 1980. Annual consumer price increases ranged from 5 and 8 percent in Germany and Japan to 22 percent in Italy. The main difference in 1980, compared with the period following the first oil shock, was that inflation rates stabilized fairly rapidly by the middle of the year. In Germany and Japan, consumer price inflation peaked at midyear, and both countries were able to reduce the rate of their price increases considerably thereafter. Consumer prices in Germany, however, began to edge upward again toward the end of the year. The United Kingdom also achieved a measure of success. Although consumer prices rose 18 percent in 1980, the annualized monthly rate of increase averaged only 7 percent during the second half of the year. France, Canada, and Italy were relatively less successful. These countries experienced sustained or mildly accelerating consumer price inflation throughout the year.

One message that foreign policymakers were reasonably successful in conveying during the year was the need for moderation in the demands for wage increases. In both Germany and Japan, wage increases for the year of about 6 to 7 percent yielded no significant real income gains. In the United Kingdom, average wage increases relative to those a year earlier began falling to roughly 10 percent by the end of the year and real wages began to decline. Overall, wage increases for the foreign economies were expected to average about 9 percent in 1980, about the same as in 1979. But productivity growth of manufacturing slowed markedly, compared with 1979. Only Japan recorded a substantial increase in productivity, while the United Kingdom registered an actual decline. As a result, unit labor costs rose on average by some 7 percent, nearly twice as fast as they did in 1979. The increases were most pronounced in the United Kingdom and Italy; Japan alone registered no significant increases.

On balance, the influence of monetary and fiscal restraint on inflation performances in 1980 was mixed. It was clear by the end of the year that the restrictive policy stance was not entirely successful in reducing inflationary pressures. The inflation problem was still there. The questions that now had to be faced were the costs countries were prepared to accept to reduce inflation

and the policies that would offer the best promise of success without unduly prolonging the economic slowdown.

THE DEVELOPING COUNTRIES. Like the industrial countries, the nonoil developing countries, too, had to adapt their economies to the effects of the large oil price increases. They also faced many of the other problems confronted by the industrial countries: high inflation, relatively slow growth, and widening current account deficits. For the nonoil LDC group as a whole, real growth averaged slightly less than 5 percent, about the same as the year before. The range of outcomes was, however, very wide, going from a 5 percent drop in Korea to an 8 percent increase in Brazil. In most oil-importing LDCs, the growth of export volume declined, primarily because of the slowdown in aggregate demand among the industrial countries. Import growth also fell in volume terms, even though the value of imports increased markedly, largely as a result of higher oil prices. The nonoil LDCs thus were not a source of demand strength for the world economy in 1980.

The OPEC countries, by contrast, were a source of demand strength. With real imports growing by about 20 percent, their overall import bill rose to about \$140 billion. Other oil-exporting countries, such as Mexico, also had substantial increases in imports.

As the OPEC countries registered current account surpluses totaling about \$110 billion in 1980, the nonoil developing countries saw their combined current account deficits expand markedly. These deficits rose by about \$15 billion from their 1979 level to roughly \$55 billion, even after accounting for government loans and other official transfers. Payments positions ranged from near balance in Colombia to deficits of about \$5 billion in Korea and as high as \$13 billion in Brazil.

The nonoil LDCs also faced different experiences in financing their deficits. Some continued to rely on the syndicated credit markets, as they had in the past, despite some hardening in terms. Others, not wanting publicly to accept worsened terms or discouraged from seeking more funds through this market, opted for privately arranged bank loans, export credits, and drawing down reserves. As a result, borrowing by the nonoil LDCs in the syndicated credit markets fell during 1980 by almost 35 percent over the 1979 level. Overall bank lending to these countries, however, remained strong.

The relative ease with which the nonoil LDCs managed to finance their deficits

in 1980 was, nevertheless, no assurance that these countries would find the path comparably easy in future years. Many of the international banks had become concerned about their exposure in certain countries. This accounted for some of the hardening in borrowing terms during 1980, particularly for those countries already heavily in debt. To be sure, the International Monetary Fund (IMF) and the World Bank both stepped up their lending to many of these countries substantially in 1980. Even so, it was unclear whether their resources were adequate to prepare them to play a potentially larger role in the recycling process despite the increase in IMF quotas and World Bank capital during 1980. As the year drew to a close, however, efforts were under way to expand the IMF's resources by borrowing so as to ensure available funds for balance-of-payments financing by both LDC and industrial country members should the need arise.

The outlook for 1981 was uncertain. If 1980 had been a year of diversity, there was little to indicate that 1981 would be significantly different. Countries continued to face the need to maintain their fight against inflation and to reduce their current account deficits. Solving these problems would require some degree of international cooperation. For the oil-exporting countries, this could entail taking a more direct role in providing finance and contributing to international payments balance. For the rest, it would mean maintaining an open trading environment as well as adequate access for deficit countries to national and international capital markets. Above all, the oil-importing countries would have to pursue their efforts to conserve substantially more energy and to develop both oil and nonoil energy sources. As 1981 got under way, the challenges to the world economy were never greater and the need for imaginative and sustained leadership never more critical.

MONETARY CONTROL ACT

The Depository Institutions Deregulation and Monetary Control Act of 1980 (Public Law 96-221), signed into law by President Carter on March 31, 1980, is regarded by many as comparable in significance to the Federal Reserve Act, the Banking Act of 1933, and the Bank Holding Company Act of 1956. It represents a major step toward deregulating banking in the United States, introducing competition on an equal basis in the provision of all types of banking services. The act is designed to improve the effectiveness of monetary policy by applying new reserve and reporting requirements set by the Board of Governors of the Federal Reserve System for nearly all depository institutions and by generally eliminating distinctions—both costs and benefits—between member banks and other depository institutions. The International Banking Act of 1978 had already provided that foreign-owned banking institutions should be placed on an equal basis with domestic banks. Major parts of its implementation have been timed to coincide with that of the Monetary Control Act, thus extending the concept of equal treatment to all types of depository institutions operating in the United States.

DEREGULATION. Among the major provisions of the Monetary Control Act are the orderly elimination of restrictions imposed on depository institutions by Federal ceilings on deposit interest rates (Regulation Q) and the preemption of many of the controls imposed by state usury laws on loan interest rates. The Congress created a new agency, the Depository Institutions Deregulation Committee, to oversee a phaseout of the deposit interest rate limitations over a six-year period.

The Monetary Control Act permits Federally chartered thrift institutions to offer a wider range of financial services. Their additional powers will enable thrift institutions to compete more broadly with commercial banks, particularly in servicing the financial needs of households and small businesses.

The act also calls for regulatory simplification by setting a checklist with which, to the maximum extent practicable, each Federal financial regulatory agency must comply before issuing a new regulation. Extensive revisions of the Truth-in-Lending Act were included to simplify the process of informing borrowers of the cost of credit.

MONETARY CONTROL. The Monetary Control Act represents the culmination of many years of effort to impose uniform reserve requirements on all depository institutions, in order to enhance monetary control as well as competitive equity. In recent years, member banks had been leaving the Federal Reserve System in increasing numbers because of costs of the reserves borne by them and not by their competitors. Now, nearly all depository institutions are subject to Federal Reserve reserve requirements based on the nature of their deposits. The new reserve requirements recognize that, with NOW (negotiable order of withdrawal), ATS (automatic transfer service), credit union share draft, and other accounts increasingly offering the same services as demand deposits, competitive equality calls for imposing the same reserve requirement on all accounts that are used for making payments or transfers to third parties (named "transaction" accounts by the act). Reserve requirements are also imposed on non-personal time deposits and on Eurocurrency liabilities. Nontransferable personal time accounts such as savings accounts and IRA or Keogh Plan accounts held by natural persons are not subject to reserve requirements.

Under certain circumstances, supplemental reserves on which interest would be paid may be imposed by the Board of Governors. In addition, the Board was granted broad authority to require reports of liabilities and assets from depository institutions.

These changes necessitated that, in a relatively short period of time, the Bank and the Federal Reserve System as a whole formulate policy for new reserve requirements and reports, prepare major revisions in regulations, restructure reporting systems, educate a large number of new reporters, and open new reserve accounts.

In recognition of the burdensome effect the imposition of reserves and weekly reporting would have on smaller institutions, the Board of Governors granted institutions with \$2 million or less in deposits a temporary waiver from reserve requirements. Most institutions with deposits over \$2 million and less than \$15 million were allowed to submit reports of deposits quarterly instead of weekly.

The revised reserve-requirement regulation (Regulation D) contains complex phasing provisions that began November 13, 1980. Most member banks are being phased down from the old reserve requirements to the new lower levels over a 3½-year period. Nonmember depository institutions are being phased up to a full reserve requirement over an eight-year period. The reserve requirement applying to United States branches and agencies of foreign banks will be phased up to a full reserve requirement over a two-year period.

The Monetary Control Act permits depository institutions, except member banks, to maintain reserves at Reserve Banks on a pass-through basis. A non-member depository institution may maintain reserves with another depository institution that is subject to Federal reserve requirements. In addition, reserves may be maintained on a pass-through basis at a Federal Home Loan Bank or, as permitted on a case-by-case basis by the Board of Governors, at a bankers' bank. Such banks are owned primarily by depository institutions and do not do business with the general public.

FEDERAL RESERVE SERVICES. The Monetary Control Act will have a significant effect on this and other Reserve Banks' services. To date, these services, such as check collection, wire transfers of funds and securities, coin and currency, and securities safekeeping, have been offered mainly to member banks and without charge. Beginning in 1981, these services will be available equally to all depository institutions and at a fee. It is far too early to assess the impact of pricing on this Bank's operations. However, operational improvements in the past few years have placed the Bank in a good position to implement pricing.

Another fundamental change made by the Monetary Control Act is that all depository institutions with transaction accounts or nonpersonal time accounts now have access to the Reserve Banks' discount windows. The act also removed the $\frac{1}{2}$ percent penalty for advances secured by collateral not eligible for discount by a Reserve Bank. This Bank's discount window staff has met individually and with groups of depository institutions that became eligible for discount window borrowing under the act to explain the philosophy and operations of the discount window and to learn about the funding needs of these institutions.

THE BANK IN 1980

Managerial and Operational Highlights

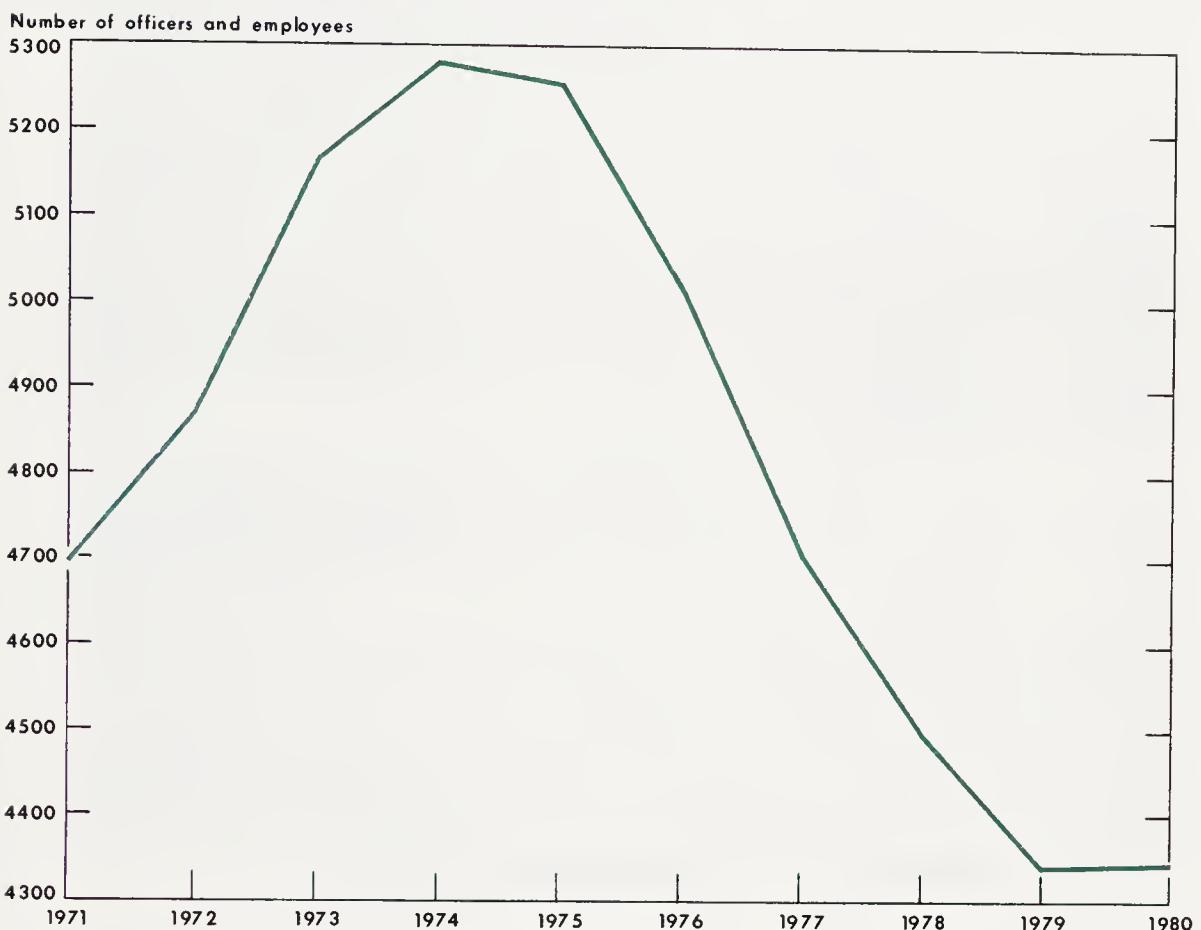
The Monetary Control Act and other developments added importantly to the complexity and total cost of Bank operations during 1980. Considerable further progress, however, was made toward improving the Bank's operational efficiency and physical plant. Productivity again increased appreciably, and unit costs rose far less than the rate of inflation. At the same time, the quality of services was maintained and improvements achieved in several areas.

Persistent inflation continued to exert upward pressure on salaries and the prices of goods and services purchased by the Bank. Additional cost pressures resulted from implementation of the Monetary Control Act, System-wide float reduction efforts, and the substantial increase in direct investment by the public in marketable Treasury issues. As a result, expenses in 1980 increased by 13 percent over 1979 levels.

Staffing remained constant in 1980, after five consecutive years of decline (Chart 11). Since the mid-1974 peak, Bankwide staffing has declined by more than 1,000 people, an average annual rate of decline of 2.6 percent. The volume of operations in 1980 continued to expand, with increases ranging from a low of 4 percent in the Check area to such high levels as 25 percent and 37 percent in the Funds Transfer and Government Bond areas. Productivity gains of 12 to 14 percent enabled the Bank to keep increases in aggregate unit costs (in measurable areas which account for two thirds of total expenses) to less than 4 percent.

The productivity and unit cost performance reflects the results of the major capital investments made in many parts of the Bank during the last six years. The installation of new check equipment and the introduction of new check processing concepts are now virtually complete throughout the District, with the final phase under way at the Utica Regional Check Processing Center. Check productivity increased dramatically, rising to more than 2,475 items per man-hour during the fourth quarter, an increase of nearly 30 percent compared with the average of 1979; meanwhile, quality has also been improving. In Cash operations, several additional high-speed currency processors were acquired in 1980, and by the year-end almost a quarter of all currency was processed on the new equipment which is better able to sort fit from unfit notes.

Chart 11. TOTAL EMPLOYMENT AT THE FEDERAL RESERVE BANK OF NEW YORK LEVELED OFF IN 1980, AFTER FIVE CONSECUTIVE YEARS OF DECLINE.



All data are year-end levels.

The results have been greater efficiency as well as improvements in the quality of currency distributed by this Bank.

The installation of a new telecommunications switch, which is expected to help the Federal Reserve meet the anticipated substantially higher volume of funds and securities transfers during the 1980s, proceeded on schedule. The related project of developing a new on-line terminal network to expand direct access to the telecommunications network by Second District financial insti-

tutions also moved along as planned. Replacement and expansion of both the telecommunications switch and the terminal network are scheduled to be completed by late 1982. Expansion of the Bank's analytical computer was accelerated to meet the new reporting requirements of the Monetary Control Act.

The Bank's ongoing role in the development and implementation of domestic and international monetary policy placed heavy demands on Bank resources given the continuing economic turbulence at home and abroad. Implementation of the Federal Reserve's special credit restraint program was a major, if temporary, undertaking. From March until July, many of the Bank's management and staff were suddenly pressed into service interpreting and applying the rules of the program which covered a broad range of financial institutions as well as retail establishments.

Soaring interest rates increased public interest in Government securities and importantly affected fiscal agency operations; the number of individuals purchasing Government securities at the Bank rose by 60 percent over 1979. Since 1977, the number of tenders for Government securities by individuals has increased ninefold in this District.

Efficiency throughout the Bank was improved, not only by continuing refinements in budgetary and planning procedures, but also by the consolidation of Bank operations in New York City into two locations, the main building and rented space across the street. The related major power project to modernize the Bank's electrical and air-conditioning systems was also completed in 1980, except for the final phase of the air-conditioning renovation.

Financial Statements

STATEMENT OF EARNINGS AND EXPENSES FOR THE CALENDAR YEARS 1980 AND 1979 (In dollars)

| | 1980 | 1979* |
|---|---|----------------------|
| Total current earnings | 3,335,892,900 | 2,590,907,017 |
| Net expenses | <u>163,597,671</u> | <u>144,046,463</u> |
| | Current net earnings | 3,172,295,229 |
| Additions to current net earnings: | | |
| Profit on foreign exchange (net) | 24,318,030 | — |
| All other | <u>209,126</u> | <u>1,474,474</u> |
| | Total additions | 24,527,156 |
| Deductions from current net earnings: | | |
| Loss on foreign exchange (net) | — | 949,579 |
| Loss on sales of United States Government securities and Federal agency obligations (net) | 50,330,254 | 37,616,259 |
| All other | <u>1,315,286</u> | <u>257,491</u> |
| | Total deductions | 51,645,540 |
| Net deductions | 27,118,384 | 37,348,855 |
| Assessment for the Board of Governors | <u>15,742,400</u> | <u>13,075,100</u> |
| | Net earnings available for distribution | 3,129,434,445 |
| | 2,396,436,599 | |
| Distribution of net earnings: | | |
| Dividends paid | 17,866,143 | 17,101,407 |
| Transferred to surplus | <u>16,122,050</u> | <u>10,042,500</u> |
| Payments to United States Treasury (interest on Federal Reserve notes) | <u>3,095,446,252</u> | <u>2,369,292,692</u> |
| | Net earnings distributed | 3,129,434,445 |
| | 2,396,436,599 | |
| SURPLUS ACCOUNT | | |
| Surplus—beginning of year | 289,884,750 | 279,842,250 |
| Transferred from net earnings | <u>16,122,050</u> | <u>10,042,500</u> |
| | Surplus—end of year | 306,006,800 |
| | 289,884,750 | |

* Figures reflect a reclassification of loss on foreign exchange for consistency with the 1980 classification.

STATEMENT OF CONDITION

In dollars

| Assets | DEC. 31, 1980 | DEC. 31, 1979 |
|--|----------------------------|----------------------|
| Gold certificate account | 3,012,103,748 | 2,841,319,270 |
| Special Drawing Rights certificate account | 665,000,000 | 459,000,000 |
| Coin | 23,700,869 | 21,001,713 |
| | Total | 3,700,804,617 |
| | | 3,321,320,983 |
| | | |
| Advances | 663,470,000 | 510,710,000 |
| Acceptances held under repurchase agreements | 776,489,237 | 703,548,343 |
| United States Government securities: | | |
| Bought outright* | 31,009,393,835 | 28,663,956,833 |
| Held under repurchase agreements | 2,029,250,000 | 1,167,670,000 |
| Federal agency obligations: | | |
| Bought outright | 2,271,605,538 | 2,025,020,242 |
| Held under repurchase agreements | 525,050,000 | 493,905,000 |
| | Total loans and securities | 37,275,258,610 |
| | | 33,564,810,418 |
| | | |
| Other assets: | | |
| Cash items in process of collection | 2,350,527,303 | 2,089,516,473 |
| Bank premises | 19,765,150 | 14,180,116 |
| All other† | 2,126,696,299 | 1,219,953,542 |
| | Total other assets | 4,496,988,752 |
| | | 3,323,650,131 |
| Interdistrict settlement account | 2,859,073,335 | 1,266,062,898 |
| | Total Assets | 48,332,125,314 |
| | | 41,475,844,430 |

* Includes securities loaned—fully secured

387,395,000

363,690,000

† Includes assets denominated in foreign currencies revalued monthly at market rates.

STATEMENT OF CONDITION

In dollars

| Liabilities | DEC. 31, 1980 | DEC. 31, 1979 |
|--|--|----------------------|
| Federal Reserve notes (net) | 35,601,390,747 | 29,934,647,497 |
| Reserves and other deposits: | | |
| Depository institutions | 6,521,343,106 | 7,320,492,985 |
| United States Treasury—general account | 3,062,266,692 | 1,252,497,929 |
| Foreign—official accounts | 145,508,759 | 207,256,087 |
| Other | 435,619,614 | 719,065,164 |
| | Total deposits | 10,164,738,171 |
| | | 9,499,312,165 |
| Other liabilities: | | |
| Deferred availability cash items | 1,384,300,095 | 711,320,060 |
| All other* | 569,682,701 | 750,795,208 |
| | Total other liabilities | 1,953,982,796 |
| | Total Liabilities | 47,720,111,714 |
| | 40,896,074,930 | |
| Capital Accounts | | |
| Capital paid in | 306,006,800 | 289,884,750 |
| Surplus | 306,006,800 | 289,884,750 |
| | Total Capital Accounts | 612,013,600 |
| | Total Liabilities and Capital Accounts | 48,332,125,314 |
| | 41,475,844,430 | |

* Includes exchange translation account balances reflecting the monthly revaluation of outstanding foreign exchange commitments.

Changes in Directors and Senior Officers

CHANGES IN DIRECTORS. In August 1980, member banks in Group 1 elected William S. Cook a Class B director for the unexpired portion of the term ending December 31, 1982. Mr. Cook, President of Union Pacific Corporation, New York, N.Y., succeeded Maurice F. Granville, Chairman of the Board of Texaco Inc., New York, N.Y., who had served as a Class B director from March 14, 1972 through December 31, 1979.

In December 1980, the Board of Governors of the Federal Reserve System reappointed Robert H. Knight a Class C director of the Bank for the three-year term ending December 31, 1983 and designated him as *Chairman* of the board of directors and *Federal Reserve Agent* for the year 1981. Mr. Knight, a partner in the New York law firm of Shearman & Sterling, has been serving as a Class C director since February 1976 and as *Chairman* and *Federal Reserve Agent* since January 1978; he also served as *Deputy Chairman* in 1976 and 1977. At the same time, the Board of Governors reappointed Boris Yavitz as *Deputy Chairman* for the year 1981. Dr. Yavitz, Dean of the Graduate School of Business at Columbia University, has been serving as a Class C director since June 1977 and as *Deputy Chairman* since January 1978.

In December 1980, member banks in Group 2 elected Peter D. Kiernan a Class A director for the three-year term ending December 31, 1983. Mr. Kiernan, Chairman and President of United Bank Corporation, Albany, N.Y., succeeded Raymond W. Bauer, Chairman and President of United Counties Trust Company, Elizabeth, N.J., who had served as a Class A director from April 15, 1977 through December 31, 1980.

In January 1981, member banks in Group 2 elected John R. Opel a Class B director for the three-year term ending December 31, 1983. Mr. Opel, President and Chief Executive Officer of International Business Machines Corporation, Armonk, N.Y., succeeded William S. Sneath, Chairman of the Board of Union Carbide Corporation, New York, N.Y., who had served as a Class B director from August 15, 1973 through December 31, 1980.

Buffalo Branch. The board of directors of this Bank redesignated Frederick D. Berkeley as *Chairman* of the Branch board for the year 1981. Mr. Berkeley, who is Chairman of the Board and President of Graham Manufacturing Co., Inc., Batavia, N.Y., has been a director of the Branch since February 1977 and served as *Chairman* of the Branch board in 1979 and 1980. The Bank's board

also appointed Carl F. Ulmer a director of the Buffalo Branch for a three-year term ending December 31, 1983. Mr. Ulmer, President of The Evans National Bank of Angola, Angola, N.Y., succeeded William S. Gavitt, President of The Lyons National Bank, Lyons, N.Y., who had been a director of the Branch since January 1978. At the same time, this Bank's directors reappointed John Rollins Burwell a Branch director for a three-year term ending December 31, 1983. Mr. Burwell, President of Rollins Container Corp., Rochester, N.Y., has been a director of the Branch since January 1979.

CHANGES IN SENIOR OFFICERS. The following changes in official staff at the level of Vice President and above have occurred since January 1980:

William H. Braun, Jr., Vice President, retired effective June 1, 1980. Mr. Braun joined the Bank's staff in 1935 and became an officer in 1956.

Roger M. Kubarych, formerly Assistant Vice President, was appointed Vice President and Assistant Director of Research effective July 1, 1980.

E. Gerald Corrigan, formerly Senior Vice President, resigned from the Bank effective July 31, 1980 to accept appointment as President of the Federal Reserve Bank of Minneapolis. Mr. Corrigan, who had been on temporary assignment as Special Assistant to the Chairman of the Board of Governors since August 1979, joined the staff of this Bank in 1968 and became an officer in 1972.

Effective January 1, 1981:

The assignment of Thomas C. Sloane, Senior Vice President and Senior Adviser, to the Administrative Services Group was terminated. He continues to have responsibility for the Management Planning Group and the Bank Relations Office.

Ralph A. Cann, III, formerly Assistant Vice President, was appointed Vice President and assigned to the Building Services Function.

The assignment of Henry S. Fujarski, Vice President, was broadened to include responsibility for the Administrative Services Group.

Roberta J. Green, formerly Assistant Vice President, was appointed Vice President and assigned to the Personnel Function.

Sam Y. Cross joined the Bank as a Senior Vice President effective February 1, 1981 and was assigned as the officer in charge of the newly established Foreign

Relations Function, which has assumed the banking relations responsibilities of the former Foreign Function. At the same time, the foreign exchange trading activities of the Foreign Function were assumed by the newly established Foreign Exchange Function; Scott E. Pardee, Senior Vice President, was assigned as the officer in charge of this Function. Incident to this organizational change, Margaret L. Greene and H. David Willey, Vice Presidents formerly assigned to the Foreign Function, were assigned to the Foreign Exchange and Foreign Relations Functions, respectively.

Neal M. Soss has accepted appointment as a Vice President, effective April 15, 1981. He will be assigned to the Bank Supervision Function, with primary responsibility for the Banking Studies Department.

Directors of the Federal Reserve Bank of New York

DIRECTORS

| | <i>Term expires Dec. 31</i> | <i>Class</i> | <i>Group</i> |
|--|-----------------------------|--------------|--------------|
| GORDON T. WALLIS | 1982 | A | 1 |
| Chairman of the Board, Irving Trust Company, New York, N.Y. | | | |
| PETER D. KIERNAN | 1983 | A | 2 |
| Chairman and President, United Bank Corporation, Albany, N.Y. | | | |
| JAMES WHELDEN | 1981 | A | 3 |
| President, Ballston Spa National Bank, Ballston Spa, N.Y. | | | |
| WILLIAM S. COOK | 1982 | B | 1 |
| President, Union Pacific Corporation, New York, N.Y. | | | |
| JOHN R. OPEL | 1983 | B | 2 |
| President and Chief Executive Officer, International Business Machines Corporation, Armonk, N.Y. | | | |
| EDWARD L. HENNESSY, JR. | 1981 | B | 3 |
| Chairman of the Board, Allied Chemical Corporation, Morristown, N.J. | | | |
| ROBERT H. KNIGHT, <i>Chairman and Federal Reserve Agent</i> | 1983 | C | |
| Partner, Shearman & Sterling, Attorneys, New York, N.Y. | | | |
| BORIS YAVITZ, <i>Deputy Chairman</i> | 1982 | C | |
| Dean, Graduate School of Business, Columbia University, New York, N.Y. | | | |
| GERTRUDE G. MICHELSON | 1981 | C | |
| Senior Vice President, R.H. Macy & Co., Inc., New York, N.Y. | | | |

DIRECTORS—BUFFALO BRANCH

| | |
|--|------|
| FREDERICK D. BERKELEY, <i>Chairman</i> | 1982 |
| Chairman of the Board and President, Graham Manufacturing Co., Inc., Batavia, N.Y. | |
| ROBERT J. DONOUGH | 1981 |
| President, Liberty National Bank and Trust Company, Buffalo, N.Y. | |
| GEORGE L. WESSEL | 1981 |
| President, Buffalo AFL-CIO Council, Buffalo, N.Y. | |
| M. JANE DICKMAN | 1982 |
| Partner, Touche Ross & Co., Buffalo, N.Y. | |
| ARTHUR M. RICHARDSON | 1982 |
| President, Security Trust Company, Rochester, N.Y. | |
| JOHN ROLLINS BURWELL | 1983 |
| President, Rollins Container Corp., Rochester, N.Y. | |
| CARL F. ULMER | 1983 |
| President, The Evans National Bank of Angola, Angola, N.Y. | |

MEMBER OF FEDERAL ADVISORY COUNCIL—1981

| | |
|--|------|
| DONALD C. PLATTEN | 1981 |
| Chairman of the Board, Chemical Bank, New York, N.Y. | |

Officers of the Federal Reserve Bank of New York

ANTHONY M. SOLOMON, President

THOMAS M. TIMLEN, First Vice President

SAM Y. CROSS, Senior Vice President
Foreign Relations

PETER FOUSEK, Senior Vice President
and Director of Research
Research and Statistics

RONALD B. GRAY, Senior Vice President
Bank Supervision

PAUL B. HENDERSON, JR., Senior Vice President
Operations Group

ALAN R. HOLMES, Senior Policy Adviser

JAMES H. OLTMAN, General Counsel

SCOTT E. PARDEE, Senior Vice President
Foreign Exchange

THOMAS C. SLOANE, Senior Vice President
and Senior Adviser
Bank Relations; Management Planning Group

PETER D. STERNLIGHT, Senior Vice President
Open Market Operations

AUDIT

JOHN E. FLANAGAN, General Auditor

FRANK C. EISEMAN, Assistant General Auditor

WILLIAM M. SCHULTZ, Assistant General Auditor

ROBERT J. AMBROSE, Manager,
Auditing Department

LORETTA G. ANSBRO, Manager,
Audit Analysis Department

ADMINISTRATIVE SERVICES GROUP

HENRY S. FUJARSKI, Vice President

ACCOUNTING

JOHN M. EIGHMY, Assistant Vice President

DONALD R. ANDERSON, Manager,
Accounting Department

KATHLEEN A. O'NEIL,
Accounting Officer

BUILDING SERVICES

RALPH A. CANN, III, Vice President

MATTHEW C. DREXLER, Manager,
Building Operating Department

SERVICE

RICHARD VOLLKOMMER, Vice President

LOUIS J. BRENDL, Assistant Vice President

RONALD E. LONG, Manager,
Service Department

ROBERT V. MURRAY, Manager,
Protection Department

ANTHONY N. SAGLIANO, Manager,
Records Management and
Postal Services Department

BANK RELATIONS

THOMAS C. SLOANE, Senior Vice President
and Senior Adviser

BRUCE A. CASSELLA, Bank Relations Officer

***JANE L. DETRA, Bank Relations Officer**

BANK SUPERVISION

RONALD B. GRAY, Senior Vice President

A. MARSHALL PUCKETT, Vice President

FREDERICK C. SCHADRACK, Vice President

†NEAL M. SOSS, Vice President

EDWARD F. KIPFSTUHL, Chief Examiner

LEON KOROBOW, Assistant Vice President

BENEDICT RAFANELLO, Assistant Vice President

JOHN M. CASAZZA,
Assistant Chief Examiner

GEORGE R. JUNCKER, Manager,
Consumer Affairs and
Bank Regulations Department

A. JOHN MAHER,
Assistant Chief Examiner

THOMAS P. MCQUEENEY,
Assistant Chief Examiner

WILLIAM L. RUTLEDGE, Manager,
Domestic Banking Applications Department

DONALD E. SCHMID, Manager,
Bank Analysis Department

BARBARA L. WALTER, Manager,
Foreign Banking Applications Department

ECONOMIC ADVISER

RICHARD G. DAVIS, Senior Economic Adviser

EQUAL OPPORTUNITY

FRANKLIN T. LOVE, Equal Opportunity Officer

*On leave of absence.

†Effective April 15, 1981.

Officers (Continued)

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SCOTT E. PARDEE, *Senior Vice President*
MARGARET L. GREENE, *Vice President*
CHARLES M. LUCAS, *Assistant Vice President*
HOWARD L. ALEXANDER, *Foreign Exchange Officer*
ROBERT D. SLEEPER, *Manager, Foreign Exchange Department*

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JOHN HOPKINS HEIRES, *Adviser*
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GEORGE R. ARRINGTON, *Manager, Foreign Relations Department*
GEORGE H. BOSSY, *Manager, Foreign Relations Department*
FRANCIS J. REISCHACH, *Manager, Foreign Relations Department*

LEGAL

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ERNEST T. PATRIKIS, *Deputy General Counsel*
DON N. RINGSMUTH, *Assistant General Counsel*
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BUILDING OPERATING; CASH; PROTECTION

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GARY S. WEINTRAUB, *Operations Officer*

MANAGEMENT INFORMATION

PETER D. LUCE, *Assistant Vice President
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THE SECOND FEDERAL RESERVE DISTRICT



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